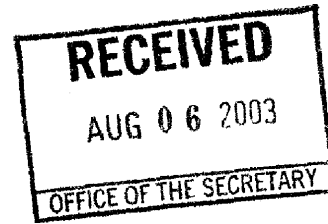


EDWARD KNIGHT  
EXECUTIVE VICE PRESIDENT

**NASDAQ**

Mr. Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549



August 5, 2003

2

Jonathan G. Katz  
Secretary  
U.S. Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, DC 20549

**Re: Primex Auction System (SR-NASD-2003-58)**

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") is filing this letter to respond to a comment letter filed by the New York Stock Exchange ("NYSE") regarding the rule filing referenced above.<sup>1</sup> The rule filing was effective upon filing.<sup>2</sup> The NYSE supports Nasdaq's proposal. However, the NYSE submitted a letter that contains inaccurate statements and shows a fundamental misunderstanding of Nasdaq's market structure.

In the proposal, Nasdaq eliminated a provision of Rule 5020 that required Primex Auction Market Makers ("PAMMs") to expose in Primex a specified percentage of certain orders in order to retain their status as PAMMs. As stated above, the NYSE supports this change.

The NYSE's letter, however, contains two inaccurate statements. First, the NYSE erroneously states that Nasdaq and ITS/CAES market makers are entitled to "jump ahead of public trading interest residing in Primex."<sup>3</sup> In actuality, Nasdaq and ITS/CAES market makers are subject to rules that prohibit them from trading ahead of their customers.<sup>4</sup> Unfortunately, the

---

<sup>1</sup> Letter from Darla C. Stuckey, Corporate Secretary, NYSE, to Jonathan G. Katz, Secretary, U. S. Securities and Exchange Commission ("Commission"), dated April 30, 2003.

<sup>2</sup> Securities Exchange Act Release No. 47645 (Apr. 8, 2003) 68 FR 17974 (Apr. 14, 2003).

<sup>3</sup> *Supra* note 1.

<sup>4</sup> NASD Rules IM-2110-2 and 6440.

**NYSE** has made similar charges in the past and Nasdaq has filed letters with the Commission and others correcting the public record? Copies of these letters are enclosed. Nevertheless, the NYSE continues to repeat these erroneous assertions.

Second, the NYSE states that PAMMs are not market makers. The NYSE is wrong again. Before an NASD member can become a PAMM, it must first be a Nasdaq market maker or an ITS/CAES market maker.<sup>6</sup> Nasdaq and ITS/CAES market makers, among other requirements, must maintain two-sided quotes at all times. The NYSE concedes this point. For some reason, however, the NYSE concludes that Primex is a separate market in which market makers must maintain quotes in addition to those they already submit to Nasdaq and the InterMarket.<sup>7</sup>

Primex is not a separate market. Primex is voluntary execution system provided to **NASD** members.<sup>8</sup> In reaching their conclusion, the NYSE had to ignore Nasdaq's repeated statements that Primex is a voluntary

---

<sup>5</sup> Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Jonathan G. Katz, Secretary, Commission, dated November 30, 2001; and letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to The Honorable Doug Ose, U.S. House of Representatives, dated April 21, 2003.

In their current comment letter, the NYSE refers to a previous comment letter submitted with respect to Primex wherein they rely on Section 11(b) to support their proposition that internalization by market makers is impermissible. Section 11(b) applies to exchange specialist. The NYSE's reliance is misguided. As the NYSE is well aware, Nasdaq is not presently registered as an exchange and Nasdaq utilizes competing market makers and ECNs, not specialists. Nasdaq previously addressed this issue in its letter to The Honorable Doug Ose on April 21, 2003, which is attached.

<sup>6</sup> NASD Rule 5020(b).

<sup>7</sup> Nasdaq InterMarket is Nasdaq's facility for, among other things, collecting quotes from ITS/CAES market makers.

<sup>8</sup> Securities Exchange Act Release No. 45982 (May 23, 2002) 67 FR 38163, 38171 (May 31, 2002) ("The [Primex] System is voluntary."); Securities Exchange Act Release No. 47251 (Feb. 11, 2003) 68 FR 8055, 8056 (Feb. 19, 2003) ("Primex is a voluntary system available to any NASD member and other entities that a member chooses to sponsor."); Primex Auction System – File No. NASD-PILOT-2001-01 ("The [Primex] System will be a voluntary service, operated as a facility of Nasdaq."); *NASD Notice to Members* 00-65 ("The Primex Auction System will be made available on a voluntary basis to any interested NASD member . . . . No NASD Rule will require an NASD member to use Primex in meeting a member's best execution obligations.").

Jonathan G. Katz

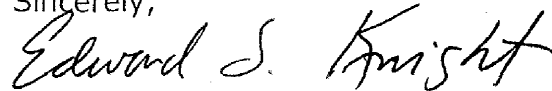
August 5, 2003

Page 3

system offered as an additional tool to execute orders in Nasdaq and listed securities, including NYSE-listed securities. Neither Nasdaq nor the Commission has ever considered Primex a separate market. Therefore, there is no requirement to maintain separate quotes in Primex.

If you have any questions regarding our proposal or this letter, you can contact me at (202) 912-3030, or Peter R. Geraghty, Associate General Counsel, Nasdaq, at (202) 912-3036.

Sincerely,

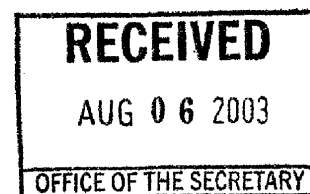
A handwritten signature in black ink that reads "Edward S. Knight". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Edward S. Knight

Cc: The Hon. William Donaldson, Chairman  
The Hon. Cynthia Glassman, Commissioner  
The Hon. Paul Atkins, Commissioner  
The Hon. Roel Campos, Commissioner  
The Hon. Harvey Goldschmid, Commissioner  
Annette Nazareth, Director, Division of Market Regulation  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Elizabeth King, Associate Director, Division of Market Regulation  
John Polise, Senior Special Counsel, Division of Market Regulation  
Jennifer Colihan, Senior Special Counsel, Division of Market Regulation  
Rebekah Liu, Special Counsel, Division of Market Regulation  
Tim Fox, Counsel, Division of Market Regulation



Edward S. Knight  
Executive Vice President and General Counsel



November 30, 2001

Jonathan G. Katz  
Secretary  
U. S. Securities and Exchange Commission  
450 Fifth St., N.W.  
Washington, D.C. 20549

**Re: File No. 10-131; Nasdaq's Exchange Registration – Response to Comments**

Dear Mr. Katz:

The Nasdaq Stock Market, Inc. ("Nasdaq") has reviewed the comment letters submitted to the Securities and Exchange Commission ("SEC" or "Commission") in response to Nasdaq's application for registration as a national securities exchange. Thirty-five commenters generally expressed support for Nasdaq becoming registered as an exchange, including twenty-three Members of Congress. Four commenters expressed no discernable opinion, and only seven commenters outright opposed Nasdaq's application. This letter responds to the issues raised by the commenters. Nasdaq respectfully submits that none of the issues raised by the commenters should further delay the SEC's approval of Nasdaq's application.

We begin with an executive summary that explains Nasdaq's market principles and why exchange registration is so critical to Nasdaq's ability to compete domestically and internationally. We then provide a detailed response to each issue raised by the commenters, and explain why the commenters either are incorrect, or raise broader market structure issues that go well beyond the scope of, and should not be considered in reviewing, Nasdaq's exchange application.

*I. Executive Summary*

Over the past 30 years, Nasdaq's ability to respond to a changing market and investors' needs has been possible because it adheres to the principle of providing broker-dealers and listed companies with choices as to how they participate in Nasdaq.<sup>1</sup> This

---

<sup>1</sup> Nasdaq's success in attracting and retaining listed companies is due to many factors, including providing issuers with flexibility. Nasdaq has a two-tiered listing structure that

and **listed** companies with choices **as to** how they **participate** in Nasdaq.’ This **philosophy**, combined **with a** commitment to fairness and **transparency**, has produced a **market that has** been beneficial to investors, listed-companies, and the firms **that trade on Nasdaq**, resulting in Nasdaq becoming the **largest stock market** in the world **as measured by dollar value of equity trading**.’ In fact, Nasdaq is a vital component **of the overall U.S. economy**. This is self-evident from a **quick review** of the **companies listed on Nasdaq**.

Nasdaq is **the market of choice** for some of the world’s best-known companies — companies whose products are used by **people every day, the world over**. It is not uncommon for **a** consumer to begin their day with a cup of **Starbuck’s coffee**, and then turn on his **or her Dell** computer, which runs Microsoft **software**. This **person may then catch up on the latest news stones on the web**, which **is possible because of companies like Cisco and Yahoo!** **While surfing the web**, the consumer could **shop at Amazon.com or Bed, Bath and Beyond**, or **participate** in an Ebay auction. These **companies are just a few examples** of the more than 4,000 companies listed on Nasdaq.

Nasdaq **believes** that its market principles and the attendant benefits to investors **can be replicated** throughout the world, and has set out to become the first truly **global exchange**. Nasdaq is **working to set up** an electronic **linkage** that will enable listed-companies to tap new pools of investors, whether they are located in the **United States, Europe, or Asia**,

---

<sup>1</sup> Nasdaq’s success in attracting and retaining listed companies is **due to many** factors, including **providing** issuers with **flexibility**. Nasdaq has **a two-tiered listing structure that is designed to** enable companies of varying size and **maturity to** obtain a **listing and access the liquidity of the Nasdaq market**. Larger companies **can obtain a listing on the Nasdaq National Market,**<sup>®</sup> while smaller companies can **list on the Nasdaq SmallCap Market.**<sup>SM</sup> Other exchanges do not share Nasdaq’s philosophy, and **seek to attract only the largest companies**. Therefore, Nasdaq meets a critical **need** in the **capital markets by providing a market** for companies of many sizes and stages of **development**.

The broker-dealers that **trade on the Nasdaq market also have** contributed greatly to the success of Nasdaq. In particular, **market makers risk** their own **capital to ensure** there is **always a buyer and seller for a security, and electronic communication networks (“ECNs”)** have developed **alternative trading systems** within **the Nasdaq market framework that have** fostered increased liquidity and depth for **Nasdaq stocks, Nasdaq’s market structure, which includes voluntary execution systems, has provided the flexibility needed to enhance market efficiency and develop innovative order handling and execution systems**.

<sup>2</sup> Nasdaq trades more shares than **any other U.S. exchange**. In 2000, Nasdaq’s share volume topped other major U.S. **markets on all 252 trading days – making Nasdaq the most active U.S. stock market** in terms of share volume. In addition, Nasdaq traded over 1 billion shares on 250 of 252 trading days in 2000. From 1999 to 2000, Nasdaq experienced a 1,227% growth in **share volume**. *Nasdaq In Black & White 2001*.

**and allow these** investors to trade with each other from their **local** market. Registering as a **national securities exchange** in the United States is a vital **step** in the evolution of **Nasdaq**, and is critical to its ability to fulfill its goal of becoming a truly global exchange. This is a fact **well** known to **Nasdaq's** competitors, whose **self-interest** is served by any delay in Nasdaq obtaining registration as an **exchange**.

**Nasdaq's** ability to pursue its goals has already been hampered by the lack of certainty with respect to its status as an exchange.<sup>3</sup> This is **because Nasdaq's** current **management structure, required by** virtue of its current **regulatory** status as a facility of the National Association of Securities Dealers, Inc. ("**NASD**"), **requires** that **any** arrangement with a **potential** business **partner** be subject to review by the **NASD** Board of Governors, which includes **representatives** from the American Stock **Exchange, Inc. ("Amex"), a competing exchange**. In addition, **Nasdaq's** evolution into a national securities exchange is critical to its ability to **raise capital** for technology and operational improvements that will permit **Nasdaq to respond to** growing competition from foreign markets and ECNs, some of which already have access to the capital markets. In contrast, **while Nasdaq has sold shares in a private placement**, it cannot receive the full benefits of access to the capital markets until it achieves its independence from the **NASD**, by becoming an exchange. **Again, this** fact is well known by Nasdaq's competitors, which benefit by any **delay in Nasdaq becoming an exchange**.

In reviewing Nasdaq's exchange application and the comment letters, it is important for the **Commission** to recognize these competitive implications. It is **also important that the** Commission recognize that the Nasdaq exchange will operate in all **material respects just as Nasdaq operates** today as a facility of the **NASD**. In fact, **because** obtaining exchange status is **so vital to its** future, Nasdaq has proposed to retain the **same** robust regulatory infrastructure, through its contract with the **NASD**, and has deliberately limited changes to its rules and operations to only those changes that were absolutely required by virtue of **Nasdaq** becoming independent of the **NASD**. This means Nasdaq is retaining the same market structure, and, thus, is different from any other **currently registered exchange**.

**As described above**, freedom of choice is one of the foundations of this market structure. Unlike a **traditional securities exchange** that houses a centralized, auction **market**, Nasdaq **is** a decentralized, competing dealer market that uses sophisticated technology to connect market participants located throughout the United States. Moreover, much of **Nasdaq's success stems** from Nasdaq's "open architecture" model that **provides broker-dealers with the flexibility to develop** innovative methods for **executing** transactions in a **cost-effective and efficient** manner. **Although Nasdaq's** market structure is **different**, **Nasdaq believes**

<sup>3</sup> For example, approximately seven months ago Nasdaq's discussions with a foreign exchange about forming a global alliance broke down due, in part, to the uncertainty surrounding the status of Nasdaq's exchange registration,

Jonathan G. Katz  
November 30, 2001

that, so long as the Nasdaq exchange has **an appropriate regulatory infrastructure** and **is organized** in a manner that meets the standards in the Securities Exchange Act of 1934 (“Exchange Act”), the Commission must **approve** Nasdaq’s application.

Certain commenters suggest in their submissions, either directly or **implicitly**, that **only an exchange** that **maintains an** auction process for trading securities **can meet the** standards contained in the **Exchange Act**.<sup>4</sup> Nasdaq **recognizes** that it **would be the** first electronic **marketplace** to be registered as a national **securities exchange** that **does not have a** mandatory **central** execution system. **However, the traditional elements of an** auction **market**, including **a** physical trading floor **with** designated trading **locations** and a central limit order **book**, **are not required** for an exchange **to meet** the definition **or** requirements of the **Exchange Act**.

Moreover, the **Nasdaq rulebook** **is** based on the rules of the **NASD**, which have been in place for many years and are time-tested as effectively governing Nasdaq’s **market**. These **NASD** rules have been vetted through the SEC’s rule **review process under Section 19** of the **Exchange Act**. Moreover, the regulatory, surveillance and enforcement functions **will be** provided by **NASD Regulation, Inc. (“NASDR”)**, which **has enhanced** its facilities, its staffing and its processes substantially in recent **years**. **Nasdaq’s governance**, more than that of any other marketplace, reduces conflicts of interest **between** running a market **and regulating a market**. **Finally, Nasdaq believes that its competing dealer** structure promotes **fairness**, efficiency, **transparency** and innovation. **In short, Nasdaq believes it has fully met** the **statutory** standards for **exchange qualification** and that its application should be **approved** promptly.

With respect to **the** specific issues raised **by** the commenters, **Nasdaq believes** that **the** commenters **are** either incorrect in their **analysis** or are raising broader market **structure** issues that should not be considered in the context of **Nasdaq’s exchange registration**. **In the former category are** commenters’ suggestions: that **Nasdaq’s Form 1 is incomplete**; that **the public** comment period **was** insufficient; that **a de novo review** of Nasdaq’s rules **needs to be conducted**; that **Nasdaq’s for-profit status** is inconsistent **with the Exchange**

---

<sup>4</sup> Some commenters believe the terms “exchange” and “equal regulation” mean that **Nasdaq** must adopt their **market** structure – **an auction market**. These commenters demand that the SEC impose on Nasdaq the traditional elements of **an auction market**. **These features**, such as a central limit order book, are not required by law or **policy**. **These commenters** believe the term “exchange” as defined in the **Exchange Act**, and supplemented by Rule 3b-16, sets **a rigid** formula that all **exchanges must meet to be** registered. **Such an** interpretation has no statutory **basis and is** inconsistent **with the** legislative **history** of the **Exchange Act** and **recent SEC policy**, such as the **adoption of Regulation ATS**. See **Securities Exchange Act** Release No. 40760 (Dec. 8, 1998), **63 FR 70844** (Dec. 22, 1998) (“**Regulation ATS Adopting Release**”).

**Act**; that inappropriate conflicts of ~~interest~~ **exist** between Nasdaq and NASDR; **that the Exchange Act requires** a central limit order book and a “trade through” **rule**; **that it is improper** for Nasdaq to split off from *the NASD*; and that Nasdaq **will** be unable to participate in existing National Market System Plans. In the latter category are commenters’ arguments that: data collection and distribution **issues should be resolved** in the **context** of Nasdaq’s exchange registration; and that **the availability of an NASD residual facility** to accommodate quotation dissemination and **trade** reporting for trading that may **occur** in Nasdaq and other **exchange-listed stocks** otherwise than on a national securities exchange (hereinafter referred to as the “residual **facility**”) **should be a prerequisite or condition for approval** of Nasdaq’s exchange registration.

The following detailed discussion provides Nasdaq’s response to commenters on **each** of these issues.

## **II.      *Response to Specific Comments***

### **A.      Nasdaq’s Form 1 is Complete and Interested Persons have had Sufficient Time to Comment**

Several commenters argue that the SEC should not **approve** Nasdaq’s **application for registration** as a national securities exchange because the Form 1 **filed by Nasdaq is incomplete**. **These** commenters assert that the SEC and **the public have been denied an adequate record to determine whether the application is consistent with the Exchange Act**. These commenters want Nasdaq to explain its rationale for each **rule** submitted and/or **explain** the changes made **to** the existing rules. These commenters also believe a red-line version of **the rules** is necessary to **review** the application, and that Nasdaq should indicate whether certain NASD rule changes **approved** after the date **Nasdaq filed its application** will be included as Nasdaq **rules** (e.g., SuperMontage). **These commenters also** complain that **the** comment period was too short. Finally, **these commenters believe the SEC cannot approve Nasdaq’s application until the public has reviewed the NASD’s rules for its residual facility**.

Nasdaq filed its **application** on November 9, 2000, and **supplemented the filing on March 15, 2001**. The SEC deemed **the application complete as of March 15, 2001**.<sup>5</sup> **Therefore, arguments that the application is incomplete are moot, including the argument that the NASD rules for the residual facility are a necessary component to review Nasdaq’s application**. In addition, neither Section 19 of the Exchange **Act** nor Form 1 **thereunder**, which **prescribe** the requirements for filing an application to register as a national

---

<sup>5</sup> Securities Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (“Exchange Registration Notice”) at note 2.



Jonathan G. Katz  
November 30, 2001

securities exchange, require an applicant to explain the rationale for each rule or provide a red-lined version of the rules.

Moreover, commenters have had more than a sufficient opportunity to comment on Nasdaq's application and rules package – particularly in light of the fact that most Nasdaq exchange rules have their origins in the NASD rules that currently apply to trading on Nasdaq. In addition, the comment period was extended from July 30, 2001 until August 29, 2001.<sup>6</sup> The public, therefore, has been provided with more than adequate time to review the application before the comment period expired. Furthermore, the SEC continues to accept comment letters after the close of the comment period, which provides commenters even more time to review the application.<sup>7</sup> Amendment No. 1 incorporates into Nasdaq's proposed rules those NASD rule changes approved after Nasdaq filed its exchange application.<sup>8</sup> These rules, of course, have been subject to review under the standard rule filing process.

---

<sup>6</sup> Securities Exchange Act Release No. 44625 (July 31, 2001), 66 FR 41056 (Aug. 6, 2001).

<sup>7</sup> The following comment letters were submitted after expiration of the extended comment period: Letter from W. Hardy Callcott, Senior Vice President and General Counsel, Charles Schwab & Co., Inc., to Jonathan G. Katz, Secretary, SEC, dated August 30, 2001; Letter from the Honorable Don Nickles, U.S. Senator, to Jonathan G. Katz, Secretary, SEC, dated August 30, 2001; Letter from Stuart J. Kaswell, Senior Vice President and General Counsel, Securities Industry Association, to Jonathan J. Katz, Secretary, SEC, dated August 30, 2001; Letter from the Honorable Jerry Weller, Member of Congress, to Jonathan G. Katz, Secretary, SEC, dated August 31, 2001; Letter from Meyer S. Frucher, Chairman and Chief Executive Officer, Philadelphia Stock Exchange, Inc. ("Phlx"), to Jonathan G. Katz, Secretary, SEC, dated September 4, 2001; Letter from Thomas N. McManus, Executive Director and Counsel, Morgan Stanley Dean Witter, to Jonathan G. Katz, Secretary, SEC, dated September 4, 2001; Letter from George W. Mann, Jr., Senior Vice President and General Counsel, Boston Stock Exchange, Incorporated ("BSE"), to Jonathan G. Katz, Secretary, SEC, dated September 5, 2001; Letter from the Honorable Nancy Johnson, Member of Congress, the Honorable James Maloney, Member of Congress, and the Honorable Christopher Shays, Member of Congress, to Jonathan G. Katz, Secretary, SEC, dated September 18, 2001; Letter from the Honorable Mark Foley, Member of Congress, to Jonathan G. Katz, Secretary, SEC, dated September 21, 2001; Letter from Sol Reicher et. al, on behalf of the Member Associations of the American Stock Exchange, to Jonathan G. Katz, Secretary, SEC, dated October 2, 2001 ("Amex Members Letter").

<sup>8</sup> See Letter from Edward S. Knight, Executive Vice President and General Counsel, Nasdaq, to Annette Nazareth, Director, Division of Market Regulation, SEC, dated November 13, 2001 ("Amendment No. 1").

Finally, the statutory scheme for exchange registration does **not** provide for review of the NASD's rules for the residual facility in the context of Nasdaq's exchange registration because Nasdaq, not the NASD, is the exchange "applicant." Section 19(a)(1) of the Exchange Act provides that the Commission shall grant an application for registration as a national securities exchange "if it finds that the requirements of the [Exchange Act] and the rules and regulations thereunder *with respect to the applicant* are satisfied." (Emphasis added.) Section 6 sets forth the requirements of the Exchange Act with respect to applications for exchange registration. In particular, Section 6(b) provides that **an exchange shall not be registered as a national securities exchange unless the Commission makes a number of findings designed to ensure that the exchange is organized to carry out the purposes of the Exchange Act. All of the requirements of Section 6(b) relate to the rules and organization of the exchange itself, as the "applicant," and do not require – or more importantly, permit – the Commission to consider factors unrelated to the applicant.** Thus, under the statutory scheme for exchange registration, the Commission should not delay Nasdaq's exchange registration pending the NASD's filing of its residual facility rules, given that Nasdaq – not the NASD – is the "applicant."<sup>9</sup>

#### B. The SEC Staff Need Not Conduct a *de novo* Review of Nasdaq's Rules

Several commenters state that the SEC must conduct a *de novo* review of Nasdaq's rules under the standards applicable to registered securities exchanges. These commenters contend that the standards applicable to registered securities exchanges are different from those applicable to a registered securities association. Both of these assertions are incorrect.

---

<sup>9</sup> Moreover, the NASD and Nasdaq are not one in the same, or "co-applicants" in connection with Nasdaq's exchange registration. The NASD and Nasdaq are separate legal entities, and the Commission has acknowledged as much. See e.g., Securities Exchange Act Release Nos. 42983 (June 26, 2000), 65 FR 41116 (July 3, 2000); and 44174 (April 11, 2001), 66 FR 19822 (April 17, 2001). (Commission orders approving changes to Nasdaq's By-Laws necessary to implement the Restructuring Plan approved by NASD members on April 14, 2000). Although the Plan of Allocation and Delegation of Functions by the NASD to Subsidiaries calls for a trustee, at the NASD's direction, to vote a majority of Nasdaq's outstanding common stock prior to exchange registration, Nasdaq has a separate board of directors that manages and controls the day-to-day operations of Nasdaq. Just as the SEC would not condition the effectiveness of an application for broker-dealer registration upon an undertaking by the applicant's parent organization, the SEC should not assert jurisdiction over the NASD in connection with its review of Nasdaq's exchange registration\*

First, **there** is no Exchange Act provision that requires the SEC to **conduct a *de novo* review of Nasdaq's proposed rules.**<sup>10</sup> In fact, it is common **for** the SEC **staff** to **conduct** an expedited review or permit SRO rule changes to become immediately **effective under Section 19(b)(3)(A) of the Exchange Act** if such proposed **rules are based on the rules** of another SRO. The SEC has recognized that, "absent unusual circumstances, **filings that are virtually identical to an SRO filing already approved by the Commission will be eligible for expedited treatment.**"<sup>11</sup> In Nasdaq's case, nearly every rule filed with the Form 1 **and Amendment No. 1 has been approved under Section 15A of the Exchange Act** relating to Nasdaq **as a facility** of the NASD. **In fact, Nasdaq proposed no substantive changes to previously approved NASD rules that are not affected by Nasdaq's conversion to an exchange for the very purpose of easing the SEC's and the public's burden in reviewing Nasdaq's rules and to limit the number of substantive issues,**

Second, **the statutory standards for review of national securities association rules are identical to those used for review of exchange rules.** As discussed **above**, Section 6 of the **Exchange Act** establishes the standards that **an exchange must meet to be registered as a national securities exchange.**<sup>12</sup> Section 14A of the **Exchange Act** imposes **the same requirements on a registered securities association.**<sup>13</sup> As such, the **SEC has already**

---

<sup>10</sup> We note, however, that it **appears** from the record that the SEC staff in **fact** has conducted a *de novo* review of **Nasdaq's proposed rules.** SEC staff began **reviewing Nasdaq's draft rules in May 2000**, which culminated in the filing of **Nasdaq's proposed rules along with the Form 1 on November 9, 2000.** The rules **were** published for public comment, **and the SEC staff continues to review the rules in light of the comment letters it has received.**

<sup>11</sup> **Securities Exchange Act** Release No. 35 123 (Dec. 20, 1994); **59 FR 66692, 66697 (Dec 28, 1994).** See *also* Securities Exchange Act Release No. 43860 (Jan. 19, 2001); **66 FR 8912, 8915** (Feb. 5, 2001).

<sup>12</sup> **These standards** require, among other things, that the rules of an exchange be designed to: prevent **fraudulent** and manipulative acts and **practices, to promote** just and equitable principles of trade, **to foster** cooperation and coordination with persons engaged in **regulating, clearing, settling,** processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect **the mechanism of a free and open market and a national market system,** and, in general, to protect investors **and the public interest; and** are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or **to regulate** by virtue of any **authority conferred by this title** matters not **related to** the purposes of this title or the administration of the exchange, 15 U.S.C. § 78(f)(b)(5).

<sup>13</sup> 15 U.S.C. § 78o-3(b)(6).

determined **that** Nasdaq's **rules**, including **the rules** for SuperSoes and SuperMontage, are **consistent with these** obligations under the **Exchange Act**.<sup>14</sup>

On a **related** point, Bloomberg asserts that **SuperSoes** and **SuperMontage** must be **reexamined as a combined system**,<sup>15</sup> and that these systems combined **provide Nasdaq a monopoly** in providing execution services. Nasdaq **strongly disagrees with these assertions**. **First, the SEC in fact reviewed SuperSoes and SuperMontage as a combined system**. The rule filing establishing SuperMontage **clearly states that SuperMontage is an enhancement of SuperSoes**.<sup>16</sup> In addition, the actual rule language for SuperMontage included modifications to **the rules for SuperSoes**.<sup>17</sup>

With respect to **the "monopoly"** argument, Bloomberg is attempting to **rehash arguments** it unsuccessfully asserted **when** commenting on SuperMontage and **reiterates competitive issues that the SEC has already considered**. The SEC's order **approving SuperMontage** contained a **lengthy analysis of the competitive impact of the system and found SuperMontage to be consistent with the Exchange Act**.<sup>18</sup> The SEC's **approval of SuperMontage was based on several factors**, including the fact that **Nasdaq was seeking registration as an exchange**.<sup>19</sup>

Bloomberg's **rehashed** assertions on competition **are even less compelling in the context of Nasdaq as an exchange**. The **execution facilities that are part of SuperMontage will be available only to access the quotes of market makers and ECNs that voluntarily become Nasdaq members and submit quotes**. The quotes of **exchanges trading Nasdaq securities pursuant to unlisted trading privileges ("UTP")** would be **accessible through SuperMontage's execution facilities only if the UTP exchange chooses to make it quotes accessible**. Nothing will **require a broker-dealer to become a Nasdaq member or require a UTP exchange to provide its quotes to Nasdaq the exchange**. Furthermore, **SuperSoes and SuperMontage are voluntary systems; Nasdaq members are not required to use these systems to execute transactions in Nasdaq securities**.

---

<sup>14</sup> Securities Exchange Act Release Nos. 42344 (Jan. 14, 2000), 65 FR 3987 (Jan. 25, 2000) ("SuperSoes Approval Order"); and 43863 (Jan. 19, 2001), 66 FR 8020 (Jan. 26, 2001) ("SuperMontage Approval Order").

<sup>15</sup> Letter from Bloomberg L.P. and Bloomberg Tradebook LLC, dated August 28, 2001 ("Bloomberg Letter").

<sup>16</sup> SR-NASD-99-53.

<sup>17</sup> *Id.*

<sup>18</sup> SuperMontage Approval Order, *supra* note 14, at 8048-8055.

<sup>19</sup> *Id.* at 8022, 8054.

**C. Nasdaq May Operate as a Publicly-Traded Company Consistent with the Exchange Act**

Bloomberg also **argues** that the SEC's review of Nasdaq's **proposed rules must take** into consideration **that** Nasdaq **will be** a publicly-traded company, **while** the Phlx **asserts** that **shareholders** should not be permitted **to elect** the Board. The commenters' positions are inaccurate for **several reasons**.

To begin with, Sections 6 and 19 of the Exchange Act do not include public **ownership** as a factor **to be** considered in determining whether **to grant** **an** application for exchange registration. Although Section 6 requires that members have **"fair representation"** in **the** selection of directors and in the administration of the affairs of the **exchange, the SEC** specifically has determined that this obligation does not **prevent exchanges from** structuring **themselves** as for-profit **organizations**.<sup>20</sup> **Nasdaq's** committees **and board** of directors are structured to provide all Nasdaq members, not just shareholders, **with** fair representation, consistent with the obligations of Section 6. In **particular, Nasdaq will** continue to meet **the** balancing requirements for industry, non-industry, **and public** representation as set forth in the SEC's 21(a) Report.<sup>21</sup>

Moreover, **Nasdaq believes** it is appropriate for shareholders to elect directors. Section 6(a)(3) does not **require** that members elect the directors of an **exchange**. **As stated above,** Section 6(a)(3) requires **that** the **rules of** the exchange assure a fair representation of its members in **the** selection of its directors and that one or **more directors represent** issuers and investors and not be associated with an **exchange** member, broker, or dealer. **Nasdaq's** By-Laws concerning **the** qualification, nomination, and **election of directors** **will** meet these requirements. **in addition, all Nasdaq proposed rule changes are** published for comment by the SEC, which provides **a** forum for members, **as well as non-members, to** influence **Nasdaq** proposals.

Furthermore, although **Nasdaq has** announced its *intention* to make a **public offering of stock, Nasdaq is not currently** a public company. **Sections 6 and 19 of the Exchange Act** do not include prospective factors regarding ownership or other matters **as elements to be considered when reviewing an exchange application**. **To the extent such events or changes do occur in the future, the SEC will have an opportunity to review Nasdaq's**

---

<sup>20</sup> Regulation ATS Adopting Release, *supra* note 4, at 70848, 70882-84.

<sup>21</sup> *Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and The Nasdaq Market*, U. S. Securities and Exchange Commission (Aug. 8, 1996) ("21(a) Report"). In addition, Nasdaq shareholders **have been informed of this requirement**.

**proposal** at such time. Nasdaq believes that the **Exchange Act** requires the SEC to make its determination based on **Nasdaq's** current status as reflected in **Nasdaq's Form 1**.

Bloomberg also asserts that the **Nasdaq** Board has an irreconcilable conflict of interest between its duty to shareholders to **maximize** their value and its duties to members. As the SEC already has recognized, however, there is not an inherent conflict in an exchange operating as a for-profit enterprise. In order to satisfy its **fiduciary duties under Delaware corporate law**, for example, a corporation's board of directors must **act in the best interests** of the corporation's stockholders. In order to best serve these interests, the board of a corporation whose operations are dependent upon regulatory approvals or licenses must ensure that the corporation is operating in a manner that allows it to obtain and maintain such approvals or licenses. Accordingly, in **Nasdaq's** view, the fiduciary duties of a director of a Delaware corporation are not inconsistent with a corporation's need to comply with applicable laws and regulation, but, quite to the contrary, enhance the director's incentive to ensure compliance with such laws and regulations. In the case of a national securities exchange, in order for the board to fulfill such fiduciary obligations, it would need to ensure that the exchange is operated in accordance with the Exchange Act and the rules thereunder.

**D. Nasdaq's Relationship with NASD Regulation Minimizes Conflicts of Interest to the Greatest Extent Possible**

Some commenters assert that their ability to assess **Nasdaq's** application is compromised because they do not understand the nature of the relationship between **Nasdaq** and **NASDR** once **Nasdaq** becomes registered as an exchange. Some of these commenters believe the entire Regulatory Services Agreement ("RSA") between **Nasdaq** and **NASDR** should be public, while others believe **NASDR** has a conflict of interest in regulating **Nasdaq**.

Upon being registered as an exchange, **Nasdaq** must have the capability to comply with the Exchange Act and its own rules and enforce compliance by its members with the Exchange Act and its rules. **Nasdaq's** relationship with the **NASD** will enable it to fulfill its obligation to enforce compliance by its members with the Exchange Act and **Nasdaq** rules, while minimizing the potential for conflicts of interest. The relationship also will be structured so as to eliminate duplicative regulation.

**Nasdaq** will be a self-regulatory organization ("SRO") separate and distinct from the **NASD**, and, for that matter, the American Stock Exchange or any other SRO. Pursuant to **Nasdaq** rules, however, all members of **Nasdaq** will be members of another SRO.<sup>22</sup> As

---

<sup>22</sup> Proposed Nasdaq Rule 1014(a)(15).

a **practical matter**, most **Nasdaq** members will be members of the **NASD**, due to the **statutory** obligation that **requires** nearly all registered **broker-dealers** to be members of a **registered securities** association? Section 37(d) of the **Exchange Act**, and the **rules** thereunder, **recognize** that **broker-dealers** that are members of more than one SRO could be **subject** to **duplicate** regulation, and, therefore, that it may **be appropriate** to **allocate** examination and oversight responsibility for such members (other than for market **surveillance**) to just one of the SROs. Currently, these agreements **exist** between several SROs and the **NASD**, and are filed with the SEC pursuant to **Rule 17d-2**.<sup>24</sup> **Nasdaq** will **execute** Rule 17d-2 agreements with the **NASD** in **keeping** with the **goal** of eliminating **duplicative regulation**. **As** a result, the **NASD** will be solely **responsible** for regulating joint **NASD/Nasdaq** members **with** respect to the subject matters and rules **governed** by the agreements. The Rule 17d-2 agreements between **Nasdaq** and the **NASD** will cover those **rules** that are not **unique** to trading on **Nasdaq**, such as sales practice and **general** business conduct **rules**.<sup>25</sup>

Bloomberg asserts that Nasdaq's requirement that its members also **be** members of **another** SRO is illegal? Nasdaq believes, however, that this **arrangement** is **fully** **consistent** with the **Exchange Act**. Nasdaq's position is **supported** by the fact that the SEC **approved** Rule 600 of The International Securities Exchange ("ISE"), which **requires** membership in another SRO as a prerequisite to obtaining membership in the ISE.<sup>27</sup>

**The NASD, through NASDR, will continue to conduct surveillance for trading on Nasdaq. As some of the commenters noted, Nasdaq and NASDR have executed a RSA. The RSA covers the rules that are unique to trading on Nasdaq, such as the trade reporting rules, or that apply more generally to market makers or ECNs (e.g., the SEC's**

---

<sup>23</sup> 15 U.S.C § 78o(b)(8).

<sup>24</sup> See e.g., Securities Exchange Act Release No. 42815 (May 23, 2000), 65 FR 34762 (May 31, 2000). (Order granting **approval** of plan allocating regulatory **responsibility** between the International Securities **Exchange** ("ISE") and the **NASD**.)

<sup>25</sup> **Nasdaq** has no intention to **be** the designated examining **authority** ("DEA"), pursuant to Rule 17d-1 under the **Exchange Act**, for monitoring a member's **compliance** with the financial responsibility **rules**. See Section 3(b)(40). **The staff** that **administers** the **NASDR's** **program** for reviewing members' compliance with **these rules** will **remain** **employees** of **NASDR**. **As** such, becoming a **Nasdaq** member will not **change** a **broker-dealer's** DEA. Similarly, **any** new broker-dealer should be designated to **another** SRO, consistent with **the** SEC staffs current practice of assigning **broker-dealers** to DEAs.

<sup>26</sup> See Bloomberg **Letter**, *supra* note 15.

<sup>27</sup> Securities **Exchange Act** Release No. 42455 (Feb. 24, 2000), 65 FR 11388 (March 2, 2000).

**Limit Order Display Rule**). NASDR will be Nasdaq's agent **when** conducting **surveillance of the Nasdaq market and examinations of members for compliance with Nasdaq marketplace rules and SEC rules**. NASDR also will act as Nasdaq's agent in **prosecuting disciplinary cases alleging violations of these same rules**. However, Nasdaq will have the **ultimate** responsibility for the surveillance of its **members' trading and** for conducting **disciplinary actions**. In this regard, the **Nasdaq Review Council will be appointed by the Nasdaq Board of Directors to hear appeals of disciplinary actions**. The **Nasdaq Review Council will be similar to the NASD's National Adjudicatory Council, except the individuals serving on the Nasdaq Review Council will be selected from Nasdaq member firms**.

Some commenters **believe the entire RSA should be publicly available so** that commenters can **more fully** consider Nasdaq's application.<sup>28</sup> **Neither Section 6 nor Section 19 of the Exchange Act require that any part of this contract be publicly available**. That any part of the RSA is publicly available is only because Nasdaq has filed a Form 10 under the Exchange Act **in connection with its restructuring**. In addition, it is Nasdaq's understanding that the RSA between the ISE and the NASD is not publicly available. To our **knowledge**, no other SRO makes such information available.

Some commenters **assert** that the NASD and NASDR have a conflict of interest in **providing regulatory services to Nasdaq** because Nasdaq will be **the largest regulatory services customer of the NASD and NASDR**, and, therefore, the NASD and NASDR will have a **vested interest in Nasdaq's success**. Others claim that "[b]ecause of its ongoing substantial ownership of Nasdaq, the NASD has an **economic interest in the success of Nasdaq**."<sup>29</sup>

Regardless of the specific allegation with respect to these perceived conflicts of interest, however, it is undeniable that Nasdaq's regulatory model in fact **diminishes as much as possible any conflicts of interest inherent in the self-regulatory scheme**. All SROs are **faced with potential conflicts of interest in regulating their members**. Indeed, the Commission is well aware of the potential for such conflicts that exists at **every SRO, and, therefore, monitors for these conflicts through its oversight and inspection program**.<sup>30</sup> Under Nasdaq's model, however, the staff responsible for regulating the Nasdaq market and its members will not even be employed by the same SRU – a claim that **most other SROs cannot make**.

---

<sup>28</sup> Form 10 under the Exchange Act recognizes that certain information is confidential and not required to be disclosed to the public. The RSA that was included as an exhibit to the Form 10 included sections that were redacted to protect their confidentiality. These sections were filed with the Commission on a confidential basis.

<sup>29</sup> Amex Members Letter, *supra* note 7.

<sup>30</sup> SuperMontage Approval Order, *supra* note 14, at 8051.



In fact, public policy considerations **support** granting Nasdaq's **exchange registration for the very reason** that it will eliminate the perceived conflict of interest that arises from **the NASD's** current "two-hatted" role **as** both market regulator **and** operator of the **Nasdaq Stock Market**. **The Commission** highlighted this apparent conflict in the **course of its investigation** of the NASD and Nasdaq in 1996. In the Commission's 21(a) Report, **the Commission** noted that the NASD owns and **operates** Nasdaq and also **serves as its primary** regulator? In particular, the Commission stated that "[t]his dual role **requires** the **NASD** to subordinate **its** commercial interest **as** the owner of the market to its public interest **mandate as** an SRO to protect investors."<sup>32</sup> In addition, the Rudman **Committee**, which **was appointed** in November 1994 by the **NASD's** Board of Governors **with the mandate to review** the **NASD's** governance structures and **the NASD's oversight of** the **Nasdaq market**, concluded that **the NASD's** governance structure had "blur[red] the distinction **between** regulating the **broker-dealer** profession **and overseeing** the **Nasdaq Stock Market**."<sup>33</sup> The granting of **Nasdaq's exchange registration** will **separate these two** functions completely and permit the **NASD** to focus on overseeing the **broader broker-dealer** community without having NASD resources diverted to operating **The Nasdaq Stock Market**. Therefore, granting Nasdaq's exchange registration **actually reduces any perceived** conflicts of interest.

**E, Nasdaq Initially Intends To Continue Participating in the National Market System Plans As It Does Today and Ultimately Withdraw as Plan Processor for the OTC/UTP Plan**

Some commenters claim they are unable **to** determine whether Nasdaq's **application is** consistent **with the Exchange Act** because Nasdaq **has not explained** how it will **participate** in the relevant National Market System ("NMS") Plans.<sup>34</sup> Some of these **commenters** also **address the lack** of an "ITS-type" **linkage** for intermarket **trading of** **Nasdaq securities**. These commenters raise issues that **cover the entire spectrum with respect** to intermarket linkage. Some believe that Nasdaq must **be required to provide**

<sup>31</sup> 21(a) Report, *supra* note 21.

<sup>32</sup> *Id.* at 8.

<sup>33</sup> *Id.* at 10; citing Report of the NASD Select Committee on Structure and Governance (September 15, 1995).

<sup>34</sup> Nasdaq currently is a **participant** in the Joint Self-Regulatory Organization Plan Governing the Collection, Consolidation and Dissemination of Quotation and Transaction Information for Exchange-Listed Nasdaq/NMS Securities and for Nasdaq NMS securities Traded on Exchanges on an Unlisted Trading Privilege Basis ("OTC/UTP Plan"). Nasdaq also is a member of the Consolidated Tape Association ("CTA"), Consolidated Quotation ("CQ"), and Intermarket Trading System ("ITS") plans (collectively, the "NMS Plans"),

such a linkage, while others believe the participants in the OTC/UTP Plan must decide the intermarket linkage issue.

As described in more detail below, Nasdaq has been working for over a year to amend the NMS Plans to facilitate Nasdaq's continued participation according to the terms on which it participates today. Specifically, Nasdaq will continue to collect, consolidate, and disseminate quotes and trade reports in Nasdaq-listed securities; it will continue to send to the Securities Industry Automation Corporation ("SIAC"), as processor for the CTA plan, quotation and trade report information in Network A and Network B securities; and it will continue to participate in ITS via the Computer Assisted Execution Service ("CAES"). Nasdaq, in its role as an exchange, will only collect these trade reports and quotes from Nasdaq members. Nasdaq has worked diligently to minimize the impact on other exchanges and market participants resulting from its registration as a national securities exchange. Nasdaq notes that the SEC, as a last resort, could approve Nasdaq's exchange application contingent on final resolution of its participation in the NMS Plans, as it did in approving the application of the ISE.

#### 1. The OTC/UTP Plan

As it does today, Nasdaq will continue to play two roles in the NMS relating to Nasdaq-listed issues, Nasdaq will operate as an exchange that collects, consolidates, and disseminates quotes and trade reports from its members, and will build and operate systems that enable its members to execute transactions in Nasdaq-listed securities, consistent with Section 6 of the Exchange Act.<sup>35</sup> In addition, for the short term, Nasdaq will continue in its role as the "Plan Processor" for the OTC/UTP Plan, which was established to permit the consolidation of exchange and over-the-counter quotations and trade reports for Nasdaq National Market stocks? As the Plan Processor for the

---

<sup>35</sup> Among the systems that provide the core functionality of the Nasdaq market are its quotation display device, the Nasdaq Workstation II ("NWII"), its execution systems – the Nasdaq National Market Execution System ("SuperSOES") and SelectNet – and its trade reporting system, the Automated Confirmation Transaction Service ("ACT"). The NWII, SuperSOES, SelectNet, and ACT are all proprietary Nasdaq systems.

<sup>36</sup> Rule 11Aa3-2(a)(7) defines "plan processor" to mean any self-regulatory organization or securities information processor acting as an exclusive processor in connection with the development, implementation and/or operation of any facility contemplated by an "effective national market system plan." The SEC has approved the OTC/UTP Plan pursuant to Section 11A of the Exchange Act and Rule 11Aa3-2 thereunder and thus it is an "effective national market system plan." As is true today, once Nasdaq becomes an exchange, it will function as the "exclusive processor" for its own market by collecting quotation and transaction information for Nasdaq-listed securities pursuant to Nasdaq rules.

OTC/UTP Plan, Nasdaq operates facilities to collect, consolidate, and disseminate quotations and last sale reports of all markets quoting and trading Nasdaq-listed securities. The Plan will not grant participants access to the Nasdaq exchange's proprietary execution facilities, but simply require that UTP Exchange specialists have access to, and be accessible by, Nasdaq members via the telephone.<sup>37</sup> Thus, Nasdaq's "Plan Processor" functions are separate and distinct from the Nasdaq exchange's functions and proprietary systems.

Nasdaq dearly contemplates continuing to be a part of the OTC/UTP Plan once its application for exchange registration is approved. Nasdaq is working diligently with the other Plan Participants on amendments to the current OTC/UTP Plan to address the various issues that result from Nasdaq's becoming an exchange. One amendment to the Plan has already been submitted by the Plan Participants, and Nasdaq has recently distributed to the Plan Participants an additional amendment for their consideration? The adoption of these amendments would result in all OTC/UTP Plan changes necessary to accommodate Nasdaq as a national securities exchange.

Nasdaq contemplates a significant change in its relationship to the UTP Plan, however, once it becomes an exchange. In this regard, Nasdaq has announced to the Plan Participants its current intention not to continue to serve as the Plan Processor for the UTP Plan, and to act as an "exclusive processor" only with respect to its own market information pursuant to Section 11A(b)(1) of the Exchange Act. That is, Nasdaq will only collect, consolidate, and disseminate quotes and trade reports from its members. This action would separate Nasdaq's role as an exchange from its role as Plan Processor and eliminate a relationship that several commenters have incorrectly identified as creating a conflict of interest.

---

<sup>37</sup> The SEC established this policy in its 1985 report, *Unlisted Trading Privileges in Over-the-Counter Securities*. See Securities Exchange Act Release No. 22412 (September 16, 1985), 50 FR 38640, at note 89 and accompanying text. The SEC rejected calls for a "more sophisticated intermarket trading linkage" similar to ITS/CAES, but urged the participants to develop suitable access mechanisms, such as the UTP Line that was later developed. Nasdaq believes that the issue of linkage is unrelated to its application to register as an exchange.

<sup>38</sup> This latter amendment (Amendment No. 13) was provided to the Plan Participants on November 1, 2001, and would: add the NASD as a new Plan Participant; accommodate the submission of a single BBO and last sale by Nasdaq (rather than the full quote montage it now submits as an association); accommodate the submission of the full quotation montage of the NASD's residual facility; and remove what will, upon registering as an exchange, become Nasdaq proprietary data from the Plan Processor data streams.

Moreover, while Nasdaq is prepared to continue to serve as the OTC/UTP Plan Processor on a temporary basis until the Plan Participants select or create a new Plan Processor, Nasdaq has announced to the Plan Participants that it has undertaken a significant, internal technological modification to separate its Plan Processor systems from its market systems. Nasdaq's new technology will create a separate, internal securities information processor ("Internal SIP") to accept quote and trade information from all UTP Exchanges, including Nasdaq, on equal terms. The Internal SIP will accept best bid and offer ("BBO") and last-sale information from each UTP exchange as well as the full quotation montage and last-sale information from the NASD's residual facility. It also will provide three UTP data feeds consistent with SEC Rule 11Ac1-1: (1) the National Best Bid and Offer ("NBBO") along with the BBOs of each exchange; (2) a consolidated last sale data stream; and (3) the full quotation montage of the NASD's residual facility.

Some commenters claim that operating the Plan Processor provides Nasdaq an unfair advantage in offering execution services through its exchange marketplace. Nasdaq believes that the opposite is true – that serving as the Plan Processor actually hinders Nasdaq's ability to compete on a level playing field with other exchanges. Nasdaq often must consider and address concerns of its competitors prior to implementing changes that, but for its role as Plan Processor, Nasdaq would undertake without consulting the other exchanges. In any case, because Nasdaq is separating its market functions from its Plan Processor functions even before a new Plan Processor is created or designated, Nasdaq believes that it has addressed fully the criticism of the commenters in this regard. Additional progress needs to be made to finalize the needed changes to the existing OTC/UTP Plan, but Nasdaq strongly believes that the competitive issue in this regard is moot, and that Nasdaq's application "does not impose any burden on competition that is not necessary or appropriate in furtherance of the Act."<sup>39</sup>

## 2. The CQ, CT and ITS Plans

- Nasdaq is also working actively with the other market centers to make needed changes to the other NMS plans. In February of 2001, Nasdaq proposed amendments to the CQ, CT and ITS Plans that would permit Nasdaq to continue to participate in the Plans governing exchange-listed securities in the same manner as today. For example, Nasdaq will retain CAES as the execution system for trading among Nasdaq market makers that trade CQS securities on Nasdaq, and it will continue as the interface to ITS. Once Nasdaq is an exchange, CQS securities will be traded on Nasdaq pursuant to unlisted trading privileges, as opposed to being trading in the OTC market? Market makers and other broker-dealers, however, will continue to have the option of trading these securities in the

---

<sup>39</sup> 15 U.S.C. § 78f(b)(8).

<sup>40</sup> See 15 U.S.C. § 78l(f).

OTC market. Accordingly, the NASD will continue to collect quotes and trade reports for the OTC market. In October 2001, the ITS Operating Committee formed a special subcommittee to accomplish all necessary revisions to the ITS Plan,

Nasdaq's Internal SIP project, described above, will facilitate Nasdaq's continued participation in these Plans. As an exchange, Nasdaq will transmit to SIAC its BBO and last sale information, rather than its full quotation montage. Presumably, the NASD's residual facility, as the over-the-counter market, will transmit its full quotation montage to SIAC. Nasdaq also has been working closely with SIAC to make all necessary changes to SIAC's quote collection and dissemination facilities.

**F. The Exchange Act Does Not Require that Nasdaq Implement a Central Limit Order Book or Trade-Through Rule**

Several commenters believe Nasdaq must implement a central limit order book and a trade-through rule in order to register as an exchange. Simply stated, there is no such requirement under the federal securities laws. A central limit order book and trade-through rule are traditional elements of a centralized, auction market? Nasdaq is not a centralized, auction market, but rather is a decentralized, competing dealer market? A central limit order book and a trade through rule are inconsistent with Nasdaq's market structure and, as stated above, are not required by law. Nasdaq, because of its unique market structure, however, has developed features that provide many of the same investor protections as these two traditional elements of an auction market. Moreover, we believe our market structure is superior to a pure auction market, and, thus, is more beneficial to investors.

Several commenters argued that Nasdaq must implement a central limit order book to be an exchange. Implementing a central limit order book in a decentralized, competing dealer market, however, is neither required by law nor practicable. As the phrase

---

<sup>41</sup> Securities Exchange Act Release No. 37045 (Mar. 19, 1996), 61 FR 15318 (Apr. 5, 1996). "Under the BSE's competing specialist pilot, the Exchange's rules governing the auction market principles of priority, parity, and precedence remain unchanged for quotes at the Intermarket Trading System ("ITS") best bid or offer ("BBO")." (Emphasis added)

<sup>42</sup> In contrast, "[t]he [Cincinnati Stock Exchange's ("CSE")] NSTS system was designed to centralize trading interest of geographically dispersed dealers by consolidating and disseminating the dealers' quotations, and providing a central limit order book for orders entered by multiple dealers. Thus, the NSTS system provides a central location for CSE dealers to interact in a manner similar to a traditional exchange trading floor." Securities Exchange Act Release No. 37046 (Mar. 29, 1996), 61 FR 15322 (Apr. 5, 1996), at note 79.

indicates, a central limit order **book** is designed to consolidate limit orders in one place or system so that **all orders executed** on the **exchange** can interact **with** the limit **order book**. **Nasdaq**, as explained, **does not** provide a single execution **venue on its market**. Members **will** continue to have **flexibility** within the **Nasdaq market** to **execute their orders** in a **manner that** is consistent with their duty of best execution. In addition, in contrast to **an exchange having a central limit order book**, **Nasdaq**, through **its market participants and consistent** with its **decentralized market** structure, has the **equivalent** of **multiple** limit order **books**,

**Nasdaq market makers** and **ECNs** **operate proprietary limit order books for Nasdaq securities**. These **multiple** limit order books **have many of the same** elements as traditional limit **order books** and the priority granted public customer orders. The **best-priced customer** limit orders in these books must be displayed to the public (as part of the market maker's or ECN's quote) when the customer's order **is the same or better than the market maker's quote**.<sup>43</sup> In addition, **market makers** cannot **trade ahead of these customer limit orders**? SuperMontage also has elements of a limit order **book**. **Market makers** and **ECNs** will **be able** to provide their limit order **files to Nasdaq** for **display, as appropriate, in SuperMontage**. For **example**, a **market maker** will **be able to provide multiple customer orders** at the same price. **Nasdaq** will consolidate these orders and **display them as a single quote/order, as appropriate**.

The **commenters** that believe **Nasdaq** should **be required to** adopt a trade-through **rule** do not offer **any** justification that is more compelling than the **SEC's own conclusion that imposing a trade-through rule on Nasdaq is difficult and could undermine the effectiveness** of SuperMontage. In its order **approving SuperMontage**, the **SEC** recognized that "most orders in **Nasdaq securities are executed directly between Nasdaq participants, not using Nasdaq systems**. No price/time priority **rules apply to this trading**, other than a **market maker's duty to protect its customer limit orders before trading as principal**.'@ The **SEC** further **acknowledged** that this **practice is likely to continue even after SuperMontage is implemented**, and "[t]he Commission does not **believe that entering orders into SuperMontage should be mandated**? In addition, the **SEC** stated that "requiring time **priority within SuperMontage runs the risk of reducing market**

---

<sup>43</sup> 17 CFR 240.11Ac1-4.

<sup>44</sup> Nasdaq IM-2110-2.

<sup>45</sup> SuperMontage Approval Order, *supra* note 14, at 8038.

<sup>46</sup> *Id.* See also Securities Exchange Act Release No. 37046 (Mar. 29, 1996), 61 FR 15322 (Apr. 5, 1996). "The CSE stated that it has encouraged **dealers to place** limit orders **on the NSTS book**, but that no exchange has the **authority to dictate** firm order handling practices by **requiring** firms that **place** limit orders **in the exchange's book** (footnote omitted)."

participants' willingness to enter orders into **SuperMontage**, undermining its effectiveness."<sup>47</sup> The **SEC** also recognized that: **prices displayed in Nasdaq sometimes are not the actual price** and indeed the **actual price may differ** based on the **participant accessing the quote**.<sup>48</sup> In response, the SEC stated that "[t]he Commission **does not believe that it is appropriate to require** strict time priority based on such **prices**."<sup>49</sup> The SEC concluded **that the choice of execution algorithms in SuperMontage "will allow broker-dealers to manage their orders in SuperMontage to obtain the best execution as they would "in the dealer market where time priority does not apply" (emphasis added).**<sup>50</sup>

In **approving SuperMontage**, the SEC balanced commenters' concerns about strict time priority against the reality that Nasdaq is a dealer **market that has its own unique attributes** and characteristics. To **require Nasdaq to implement a trade through-rule and a central limit order book would be a shift in policy that ignores Nasdaq's market structure**.<sup>51</sup> Again, Nasdaq **has implemented a system appropriate for its market structure**, but that **has many of the same investor protection attributes as the traditional, auction market exchange**.

**G. Nasdaq Members Voted In Favor of the Restructuring and the SEC Has Approved Steps Necessary to Implement the Restructuring**

Instinet **asserts that it is because of its affiliation with the NASD, that Nasdaq has acquired its facilities, technology, goodwill, and even its name**.<sup>52</sup> Instinet **further states that these assets were developed to help NASD members satisfy their obligation under the Exchange Act to report quotes and trades, and were developed to fulfill Congress's and the Commission's goal of promoting competition between exchange markets and markets other than exchanges**. According to Instinet, it is inconsistent with the Exchange

---

<sup>47</sup> SuperMontage Approval Order, *supra* note 14, at 8038.

<sup>48</sup> *Id.* at 8023.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.* at 8038.

<sup>51</sup> In approving the BSE competing specialist program, the SEC stated that "the Commission **supports** efforts by exchanges to **provide increased market making and competition** on their trading floors or trading systems. Such efforts should **increase the provision of liquidity services by an exchange and enable it to compete more effectively with other markets**." *Supra* note 41. It would be incongruous for the Commission to support increased **market making** for auction exchanges, but then diminish **this opportunity on Nasdaq by requiring more centralization**.

<sup>52</sup> Letter from Douglas M. Atkin, President and Chief Executive Officer, Instinet Group Incorporated, to Jonathan G. Katz, Secretary, SEC, dated August 28, 2001.

**Act to permit Nasdaq to “strip out” the assets of the NASD so that it may convert itself into a for-profit exchange.**

Instinet fails to acknowledge, however, that the membership of the NASD voted to approve the **reorganization** of the **NASD**, including the spin-off of **Nasdaq**. **At a special meeting of NASD members** held on **April 14, 2000**, **3,423** of the **5,509 NASD members entitled to vote**, and over 80% of those actually voting, voted in **favor of the restructuring**. Under **Delaware law** such **approval** constituted authorization to proceed with the restructuring. In **addition, prior to the closing** of the **first** private placement, Nasdaq obtained the approval of the SEC for amendments to its **By-Laws** and its **Restated Certificate of Incorporation necessary** to facilitate the restructuring.<sup>53</sup> **Thus, all necessary approvals** were obtained and the restructuring was widely supported by the **membership**.

Contrary to Instinet’s assertion, competition between **exchange markets and markets other than exchanges** will continue **despite** Nasdaq registering as an exchange. Regulation ATS provides a **regulatory framework** that **permits entities to operate as markets other than exchanges**. Regulation ATS is not repealed by Nasdaq registering as an exchange. **Furthermore**, the **NASD** has committed to provide the residual facility upon implementation of SuperMontage, which will ensure that **the OTC market continues as part of the national market system**, **As** discussed below, **however**, Nasdaq believes it is consistent with the **Exchange Act** to grant Nasdaq exchange registration prior to the NASD’s residual **facility** being operational.

#### **H. Nasdaq’s Exchange Registration Should Not be used as a Forum to Address Complex Market Data Issues**

**Bloomberg and Schwab raise issues** about the collection, distribution, and sale of market data, which **they both admit were** raised in the **context** of the study **by the SEC Advisory Committee on Market Information (more commonly known as the “Seligman Committee”)**. Although Nasdaq itself has proposed reforms to the system for collection and dissemination of market information,<sup>54</sup> Nasdaq’s registration as an exchange does not materially alter these market data issues. In short, the **market data issues** considered by the **Seligman Committee** should not be decided in the **context** of Nasdaq’s exchange registration.

---

<sup>53</sup> Securities Exchange Act Release No. 42983 (June 26, 2000), 65 FR 41116 (July 3, 2000).

<sup>54</sup> See **The Nasdaq Stock Market, New Approaches to Market Information**, Submission to the SEC Advisory Committee on Market Information (February 19, 2001).



**I. The Availability of the NASD's Residual Facility Should Not be a Condition to Approval of Nasdaq's Exchange Registration**

Several commenters addressed the issue of the NASD's obligations under the Exchange Act once Nasdaq is registered as an exchange. Some commenters believe Nasdaq becoming an exchange fundamentally alters competition in the United States because the OTC market will cease to exist as it does today. To preserve this level of competition, these commenters assert that the NASD's residual facility must be operational before Nasdaq can be registered as an exchange. Other commenters believe such a facility must be operational before Nasdaq is permitted to operate as an exchange. In either case, these commenters cite various sections of the Exchange Act (Sections 6, 11A, 15A, and 19) that generally require the SEC to ensure no "burden on competition not necessary or appropriate in furtherance of the purposes of the [Exchange Act]." These commenters also cite to Section 11A(a)(1)(C)(ii), which establishes as an objective of the national market system "fair competition . . . between exchange markets and markets other than exchange markets."<sup>55</sup>

Nasdaq understands the NASD has taken concrete steps to develop and build the residual facility to accommodate trading in the third market. However, the NASD committed to provide such a residual facility upon the implementation of SuperMontage,<sup>56</sup> not in connection with Nasdaq's exchange registration. Indeed, Nasdaq's exchange registration does not raise the same competitive issues that were raised by the SuperMontage proposal and that led the SEC to require the NASD's residual facility. Since these competitive issues do not exist in the context of exchange registration, the contemporaneous availability of the residual facility is unnecessary, and the Commission should grant Nasdaq's exchange registration unconditionally and grant the NASD a temporary exemption from Rule 11Ac1-1 (the "Quote Rule") and Rule 11Aa3-1 (the "Trade Reporting Rule").<sup>57</sup>

---

<sup>55</sup> In addition, in issuing notice of Nasdaq's exchange registration, the Commission stated that such registration "has implications for the NASD which, as a national securities association, will continue to be required to collect bids, offers and quotation sizes for those entities seeking to trade listed securities, including Nasdaq securities, otherwise than on a national securities exchange," Exchange Registration Notice, *supra* note 5. The Commission went on to state that the NASD's residual facility must be operational upon Nasdaq's exchange registration. *Id.*

<sup>56</sup> SuperMontage Approval Order, *supra* note 14, at 8049.

<sup>57</sup> Moreover, it is important to remember that the objective to "promote competition between exchange markets and markets other than exchange markets" is but one of many objectives of the Exchange Act and these other objectives should not be ignored. For example, other objectives include promoting economically efficient executions of securities transactions, and promoting competition between exchanges. Nasdaq believes

1. The Statutory Scheme for Exchange Registration Requires the Decoupling of the NASD's Residual Facility and Nasdaq's Exchange Application

First, as discussed above, Section 19(a)(1) of the Exchange Act provides that the Commission shall grant an application for registration as a national securities exchange “if it finds that the requirements of the [Exchange Act] and the rules and regulations thereunder *with respect to the applicant* are satisfied.” (Emphasis added.) Section 6 sets forth the requirements of the Exchange Act with respect to applications for exchange registration. All of the requirements of Section 6 relate to the rules and organization of the exchange itself; as the “applicant,” and do not require – or more importantly, permit – the Commission to consider factors unrelated to the applicant. Thus, under the statutory scheme for exchange registration, the Commission should not delay Nasdaq's exchange registration until the establishment of the NASD's residual facility, given that Nasdaq – not the NASD – is the “applicant.”<sup>58</sup>

In addition, although the Exchange Act contemplates the existence of an over-the-counter market, it does not mandate that the NASD, or any other organization or entity, operate or provide facilities to accommodate such a market. Neither Section 15A nor Section 11A – the two primary Exchange Act sections that relate to the NASD's potential market obligations in this regard – obligate the NASD to maintain such a “facility.”

2. Section 15A does not require the NASD to maintain an OTC Facility

Generally, Section 15A provides for the registration and regulation of national securities associations? However, the only provision in Section 15A that directly addresses the NASD's obligations with respect to quotations in securities is Section 15A(b)(1). This provision requires that the rules of a national securities association “include provisions

---

securities transactions, and promoting competition between exchanges. Nasdaq believes its separation from the NASD, and registration as an exchange, will allow it to reduce costs and invest in technology to make trading more efficient, which will promote economically efficient executions of transactions. Furthermore, as an exchange, Nasdaq will be contributing to the objective of promoting competition between exchanges, thus offsetting any arguable impact on competition between exchanges and markets other than exchanges.

<sup>58</sup> Moreover, as noted above, the NASD and Nasdaq are not one in the same, or “co-applicants” in connection with Nasdaq's exchange registration. See *supra* note 9.

<sup>59</sup> Section 15A was added to the Exchange Act by the Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070 (1938). The NASD is the only national securities association registered under Section 15A.

governing **the** form and content of quotations **relating** to *securities sold otherwise than on a national securities exchange* which may **be** distributed or **published** by **any** member or person **associated** with a member, and the persons to whom such **quotations** may **be** supplied. Such rules **relating** to quotations shall be **designed** to produce fair and informative quotations, to prevent fictitious or **misleading quotations**, and **to** promote orderly **procedures** for collecting, distributing, and publishing quotations.” (Emphasis added.)

It is **clear that this** provision on its face **does** not specifically **require** the NASD to establish or **maintain** a quotation reporting “facility” or **system**, such as the **extensive quotation and execution** mechanisms **operated** by Nasdaq today. Instead, **Section 15A(b)(11)** only **requires** the NASD to provide *rules* governing the form and content **of** quotations. Moreover, Congress enacted this particular subsection of Section 15A **as part of the 1964** Amendments to the federal securities laws,<sup>60</sup> at a time **when** no **computerized** quotation facilities **existed** for unlisted securities. Although such a **computerized system** may **have** been “on the horizon,” in 1964,<sup>61</sup> the specific design and **implementation of** such a **system was years away**. **Indeed**, the original Nasdaq **system was** not **operational** until February of **1971**, and the NASD was never found to **have** been in **violation** of Section 15A(b)(11) **between** the provision’s enactment **in 1964** and the initial **launch** of the **Nasdaq system** in 1971.

**Although the text** of Section 15A(b)(11) could **be read** to include NASD obligations **with respect** to **exchange-listed** securities traded over-the-counter (*i.e.*, **in** the so-called “third market”), the statutory **context**, purpose, and **legislative** history of this **provision indicate** that it refers only *to* unlisted securities. Because **the** provision requires the NASD to **have** rules **governing** the form and content of quotations for **securities “sold” otherwise than on a national securities exchange**, it theoretically could be read **to** include quotations **in the third market**. **However**, if Section 15A(b)(11) is read in the **context of the overall** purpose **of** the 1964 amendments – to improve the market for unlisted securities by, for example, extending the **Exchange Act’s** registration and reporting requirements **to OTC**

<sup>60</sup> **Securities Acts** Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565 (1964). The substance of what is now Section 15A(b)(11) **originally was enacted as** Section 15A(b)(12). The **Securities Act Amendments** of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975) (“1975 Amendments”), **among** other things, **amended** Section **J5A** to conform the provisions concerning the registration and regulation of national securities associations to those concerning national **securities exchanges**. **As part** of these conforming changes, **several** technical amendments were made to Section 15A(b)(12) and the provision was renumbered as Section 15A(b)(11).

<sup>61</sup> See Michael J. Simon & Robert L.D. Colby, *The National Market System for Over-the-Counter Stocks*, 55 Geo. Wash. L. Rev. 17, 28 (1986) (“Simon & Colby”), citing SEC, *Report of Special Study of Securities Markets of the SEC* (1963) (“Special Study”), reprinted in H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

**issuers – then** “securities sold otherwise than on a national securities exchange” should be read to mean **only** quotations for unlisted securities and not third market quotations.<sup>62</sup>

The **legislative history** of the **1964** Amendments indicates that **the purpose of Section 15A(b)(11) was to improve the quality** of quotations in **unlisted securities, which had been unreliable at best**, by providing **the NASD with specific authority and responsibility to adopt rules relating to** quotations in OTC securities. @The Senate Banking and Currency Committee Report states that the purpose of **the** amendment was **to** “clarify the authority of associations in [the area of quotations] and further impose upon them a responsibility to act.”<sup>64</sup> Moreover, the House Interstate and Foreign Commerce Committee **Report states** that the bill was intended **to strengthen** “the regulation of over-the-counter broker-dealers [by] ... [r]equiring that **registered securities associations must have rules** designed to produce **fair** and informative **retail quotations for unlisted securities.**”<sup>65</sup> (Emphasis added.) There **is** no **apparent** indication **that Congress intended** – nor that there **was a** need for – Section 15A(b)(11) **to reach** listed securities traded over-the-counter?

---

<sup>62</sup> In summarizing the purpose of the 1964 amendments as a whole, Senator Jacob Javits, Ranking Member of the Securities Subcommittee of the Senate Banking and Currency Committee, stated that “[t]he main effect of the bill will be to apply to those unlisted securities, the over-the-counter traded securities, the same disclosure and financial requirements, proxy solicitation and insider trading requirements, as currently apply, under the Securities Exchange Act of 1934, to companies listed on the stock exchanges.” 110 CONG. REC. 18383 (1964).

<sup>63</sup> See *SEC Legislation, 1963: Hearings on S. 1642 Before A Subcommittee of the Committee on Banking and Currency U.S. Senate, 88th Cong. 74* (1963) (statement of Marc A. White, General Counsel, NASD) (“The association felt that there might be something in this study report relating to quotations soon to be released which would require specific rules of the association in this area. We felt that it would be helpful to have a statutory base for those rules. And that is the reason that I think the Commission agreed to submit this particular section of the bill, or one of the reasons I might say.”).

<sup>64</sup> S. REP. NO. 88-379, at 47 (1963).

<sup>65</sup> H.R. REP. NO. 88-1418, at 2 (1964).

<sup>66</sup> Additional legislative history supports the proposition that Section 15A(b)(11) was intended to **improve the quality of** quotations in unlisted securities. **in** Senate floor debate on the bill, Senator Harrison Williams, **Chairman** of the Securities Subcommittee of the Senate Banking and Currency Committee, **stated** that under the bill “[r]egistered securities associations will be required to adopt rules designed to produce fair and informative quotations of *unlisted securities.*” (Emphasis added,) 110 CONG. REC. 18386 (1964).

A review of the SEC's Special Study also supports the conclusion that the 1964 Amendments were intended to address deficiencies in the market for unlisted securities, not the third market. Where the third market is considered in the Special Study, it is not in the context of the OTC market as a whole, but in separate portions of the Special Study. For example, the SEC addresses the problems associated with the OTC market and its suggested solutions in Chapter VII of the Special Study. Such recommendations include improvements by the NASD with respect to local and retail quotations of OTC securities. The third market, however, is addressed in Chapter VIII of the Special Study under the subheading entitled "over-the-countermarkets in exchange-listed securities." Notably, in summarizing its findings for Congress, the Commission stated that the third market is increasing in importance and beneficial to the public, but that this "conclusion calls for no action by the Commission."<sup>67</sup> Instead, the Commission found that additional data and study were needed with respect to the third market?

Finally, the Commission initially permitted the NASD to exclude from the Nasdaq system OTC quotes on listed stocks. When the NASD was designing the Nasdaq system in 1968, it planned to exclude quotes on listed stocks in order to avoid opposition from its New York Stock Exchange, Inc. ("NYSE") members? Because the Commission staff raised concerns about this limitation, however, the NASD determined to leave open the issue while it continued to develop rules governing the operation of Nasdaq.<sup>70</sup> In October 1970, responding to pressure from the NYSE and Amex, the NASD again sought approval — this time from the Commission directly — to exclude listed stocks from Nasdaq.<sup>71</sup> On October 27, 1970, the Commission reversed the previous staff position and stated that it would have no objection if listed securities initially were excluded from Nasdaq.<sup>72</sup> Thus, it is clear that the Commission recognized in 1970 that it should not require the NASD to operate a facility to accommodate trading in the third market,

3. Section 11A does not require the NASD to maintain an OTC facility

---

<sup>67</sup> *Investor Protection: Hearings on H.R. 6789, H.R. 6793, S. 1642 Before a Subcommittee of the Committee of Interstate and Foreign Commerce, 88th Cong. 35 (1964)* (letter "from William L. Cary, Chairman, SEC, to Oren Harris, Chairman, Committee on Interstate and Foreign Commerce, submitted for the record during hearings of the House Subcommittee on Commerce and Finance).

<sup>68</sup> *Id.*

<sup>69</sup> Simon & Colby, *supra* note 61, at 38, citing *Securities Industry Study (Part III): Hearings Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 92d Cong., 2d Sess. 10 (1972) ("1972 Hearings").

<sup>70</sup> Simon & Colby, *supra* note 61, at 38.

<sup>71</sup> *Id.*

<sup>72</sup> Simon & Colby, *supra* note 61, at 38, citing 1972 Hearings.

**As noted by several of the commenters, one of the broad policy goals of Section 11A is to assure fair competition “between exchange markets and markets other than exchange markets.”<sup>73</sup> However, there is nothing in the language of Section 11A that requires there to be an OTC market or that specifies what type of facilities should be in place to support QTC trading. Like many other provisions of the federal securities laws, Section 11A, which Congress added to the Exchange Act in the 1975 Amendments, was superimposed on an existing market structure that had developed over many years as a result of market forces (as opposed to government mandate) and in response to changing market dynamics (e.g., improved technology and telecommunications). The third market developed in the 1960s and 1970s in an era of fixed commission rates as a commercially viable alternative to trading on an exchange. Although one principal goal of the 1975 Amendments was to foster competition between markets – competition that, at the time, was not as robust as today – the 1975 Amendments did not mandate any particular form of competition. Indeed, a “fundamental premise” of the 1975 Amendments was that “the initiative for the development of the facilities of a national market system must come from private interests and will depend upon the vigor of competition within the securities industry as broadly defined.”<sup>74</sup> In addition, although the SEC has broad authority under Section 11A of the Exchange Act, it does not have the power to operate as an “economic czar” for the development of a national market system.<sup>75</sup> Thus, one could question the desirability of the SEC requiring the NASD to expend considerable resources to build a facility to accommodate an unknown level of trading interest, particularly when such a facility clearly is not required by the Exchange Act and is not clearly required by the public interest.**

**Nonetheless, should the Commission continue to insist upon the availability of a residual facility, it should do so only in the context of implementation of the SuperMontage trading platform. Thus, the Commission should not delay Nasdaq’s exchange registration pending the completion of such facility, but rather exercise its broad exemptive authority and grant the NASD a temporary exemption from the Quote and Trade Reporting Rules as needed until the residual facility commences operations.” Approving Nasdaq’s**

---

<sup>73</sup> Section 11A(a)(1)(c)(ii).

<sup>74</sup> S. REP. NO. 94-75, at 12 (1975).

<sup>75</sup> *Id.*

<sup>76</sup> The Commission has broad exemptive authority under both the Quote Rule and the Trade Reporting Rule. The operative language of both rules is virtually identical and provides that: “The Commission may exempt from the provisions of [the Rule], either unconditionally or on specified terms and conditions, any exchange, association, broker, dealer or specified security if the Commission determines that such exemption is consistent with the public interest, the protection of investors, and perfection of the mechanisms of a national market system.” Rule 11Aa3-1(g). See Rule 11Ac1-1(e).

exchange registration and granting such an exemption would merely preserve the *status quo* with respect to the market for Nasdaq securities until Nasdaq is prepared to implement SuperMontage and the NASD's residual facility is ready to operate.

4. The SEC should grant the NASD a temporary exemption from the Quote Rule and Trade Reporting Rule

As noted above, the initial implementation of the Nasdaq exchange will not alter the current competitive environment for the trading of Nasdaq securities in any way that necessitates the availability of an NASD residual market. Thus, granting the NASD a temporary exemption from the Quote Rule and Trade Reporting Rule until the residual facility commences operations will maintain the *status quo* by preserving the existing Nasdaq market structure and existing levels of competition among market makers, broker-dealers and ECNs.<sup>22</sup> Such an exemption, coupled with the approval of Nasdaq's exchange registration, would not disadvantage investors, broker-dealers, including ECNs, or the public, and would require no change in the way broker-dealers currently conduct their business. In particular, no ECN would be deprived of any competitive opportunity by virtue of the Commission granting the NASD these temporary exemptions and permitting the Nasdaq exchange to begin operations. For the three principal reasons outlined below, the Commission should have ample justification for finding that an exemption is in the public interest and is consistent with the protection of investors.

---

<sup>22</sup> The Quote Rule requires the NASD to collect, process and make available to quotation vendors the best bid, best offer, and quotation sizes in reported securities communicated by each member of such association acting in the capacity of an OTC market maker, along with the identity of such market maker, except when trading in the security has been suspended. Depending upon when Nasdaq becomes registered as a national securities exchange, the NASD initially may not have available a facility to "collect, process and make available to quotation vendors" the best bid, best offer, and quotation sizes communicated over-the-counter by such members in listed and unlisted securities, and thus, would be in violation of the Quote Rule. Similarly, the Trade Reporting Rule requires the NASD to file a transaction reporting plan regarding transactions in listed equity and Nasdaq securities executed by its members otherwise than on an exchange. Once Nasdaq becomes registered as an exchange, the existing trade reporting plans will need to be amended to reflect the fact that Nasdaq trades (both current third market trades and current OTC trades) will now be exchange trades and reported as such. Moreover, the NASD will have to file, and have the SEC declare effective, a separate transaction reporting plan to cover any trades in either listed or OTC securities that are effected otherwise than on, or through the facilities of, the Nasdaq exchange or another national securities exchange. Thus, absent an exemption, the NASD would be in violation of the Trade Reporting Rule with respect to its members if it were unable to provide a facility enabling the implementation of a transaction reporting plan for reporting trades in Nasdaq and other exchange-listed securities.

First, investors will be provided with the same level of protection that they have come to rely on in their dealings with Nasdaq today because *the* rules of the Nasdaq exchange *are* the current Nasdaq rules. For example, customers will continue to have the protection of Nasdaq's so-called "Manning Rule," which generally prohibits members from trading ahead of their customers' limit orders. In addition, members of the Nasdaq exchange will be subject to best execution obligations, such as those imposed by current NASD Conduct Rule 2320. Moreover, public investors may take comfort in the fact that Nasdaq, through NASD Regulation, will employ the same audit trail, surveillance systems, and examination programs that are used today.

Second, the market for Nasdaq securities will remain highly transparent if the SEC grants the NASD (but not NASD members) temporary exemptions from these rules because, far the period during the temporary exemption, broker-dealers will be displaying quotes and reporting trades to Nasdaq or another exchange. As such, market participants will have access to all the same information as exists today and there is no increased chance that a hidden market will develop. Today, NASD members must either trade through Nasdaq or through an exchange that is trading Nasdaq securities on an UTP basis. The same will be true after Nasdaq's exchange registration is approved, only such NASD members will need to become members of Nasdaq or another exchange.

Some commenters believe that requiring a broker-dealer to join Nasdaq to comply with their obligation to report quotes and trade reports (and for ECNs to comply with the terms of *the* relevant no-action letters) forces them to compete with their regulator. These commenters view the OTC market as a market where they can develop unique methods for executing transactions and are given the freedom to innovate. In contrast, they view Nasdaq, and exchanges in general, as competitors in providing execution services.

Nasdaq registering as an exchange will not diminish any market participants' ability to innovate. The Nasdaq exchange initially will operate in all material respects just as Nasdaq operates today as a facility of the NASD. Nasdaq will retain its current market structure of competing dealers and ECNs. Specifically, until SuperMontage is implemented, Nasdaq will provide the same facilities to access quotations (*i.e.*, SuperSoes, SelectNet, and SOES), thereby alleviating any concerns that Nasdaq will become an unfair competitor to certain NASD member firms once its exchange registration is approved. In addition, joining Nasdaq will be a very simple process, particularly for existing NASD member firms.<sup>78</sup> Nasdaq does not intend to charge any

---

<sup>78</sup> Subject to SEC approval, Nasdaq plans to provide current NASD members with a specified period of time from the date Nasdaq is registered as an exchange to elect to be "grandfathered in" as Nasdaq members. During this period, NASD members will not be required to undergo a new membership review process.



fee to join the Nasdaq exchange. Moreover, there are no other material barriers to becoming a member of the Nasdaq exchange. In contrast to a traditional securities exchange with a physical trading floor and limited number of "seats," there is no comparable limit on the number of Nasdaq exchange members. Finally, the requirement to join the Nasdaq or another exchange would be only temporary since, once SuperMontage and the NASD residual facility are implemented, firms would be free to terminate their Nasdaq or other exchange membership and trade through the NASD's residual market.

Third, competition in the market for Nasdaq securities will not be diminished. In considering an exemption request, the SEC should recognize that the markets have evolved substantially since the adoption of the Quote Rule and the Trade Reporting Rule. The SEC adopted these rules in the 1970s, when exchanges were not permitted to trade Nasdaq securities. Today, the Chicago Stock Exchange, the CSE, and the BSE all trade Nasdaq securities. In addition, the Amex, Phlx, and Pacific Exchange all have announced plans to begin trading Nasdaq securities in the near future. Indeed, more competition exists today for trading Nasdaq securities than ever before,

Nasdaq believes no clear mandate exists for the NASD to provide a residual facility. However, to the extent the Commission believes it is appropriate to use its discretion to require such a system, there are equally compelling reasons to approve Nasdaq as an exchange before the NASD facility is available. Unless these issues are de-coupled, Nasdaq could be placed in a position where it is ready to operate as an exchange, but cannot because the NASD has not completed the residual facility. Were that to occur, Nasdaq would have no choice but to watch on the sidelines as the global competitive landscape continued to evolve. Furthermore, so long as approval was pending, the Board of the NASD, which includes members of the Boards of Nasdaq and the Amex, would be subject to aspects of the NASD Delegation Plan that are awkward and questionable, such as exposing confidential business information of one exchange to the review of a competing exchange's board members.

Finally, if approval is suspended while the NASD develops the residual facility, Nasdaq's competitors will view the delay as an opportunity to file additional comment letters criticizing Nasdaq's exchange application and business model, a process that has the potential to undermine Nasdaq's ability to attract or retain issuers and strategic business partners. As noted above, the uncertainty about Nasdaq's regulatory status continues to have far reaching implications?

---

<sup>79</sup>

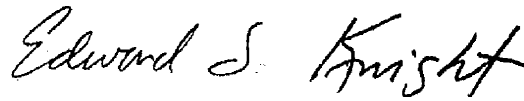
See *supra* note 3 and accompanying text.

Jonathan G. Katz  
November 30, 2001

\* \* \* \*

On the basis of the foregoing, Nasdaq believes that it has satisfied the requirements under the federal securities laws to become registered as a national securities exchange. We hope that you find this letter responsive to the comments submitted regarding Nasdaq's application. Should you have any questions regarding Nasdaq's exchange application or this response to comments, you can reach me at (202) 728-8212, or Peter R. Geraghty, Associate General Counsel, The Nasdaq Stock Market, at (202) 728-8227.

Sincerely,



Edward S. Knight

cc: The Honorable Harvey L. Pitt, Chairman  
The Honorable Laura S. Unger, Commissioner  
The Honorable Isaac C. Hunt, Jr., Commissioner  
Annette L. Nazareth, Director, Division of Market Regulation  
Robert L.D. Colby, Deputy Director, Division of Market Regulation  
Belinda Blaine, Associate Director, Division of Market Regulation  
Elizabeth K. King, Associate Director, Division of Market Regulation



EDWARD KNIGHT  
EXECUTIVE VICE PRESIDENT  
THE NASDAQ STOCK MARKET  
1501 K STREET, N.W.  
WASHINGTON, DC 20005  
PHONE 202 591 9000 FAX 202 591 1100  
edward.knight@nasdaq.com

April 21, 2003

The Honorable Doug Qse  
U.S. House of Representatives  
215 Cannon House Office Building  
Washington, DC 20515

Re: The NASDAQ Stock Market's Exchange Application

Dear Congressman Use:

**We received** a copy of a letter sent to you by the New York Stock Exchange ("NYSE") on March 24, 2003 ("March 24 letter") regarding **NASDAQ's exchange** registration application. The March 24 letter goes to great lengths, including distorting **history**, **making** unsupported statements of "law," presuming *to speak* for the Securities and Exchange Commission ("SEC") and engaging in other forms of what can only be described **as demagoguery**, to convince you that The **Nasdaq** Stock Market, Inc. ("**NASDAQ**") should not be registered as a national securities exchange under Section 6 of the Securities Exchange **Act** of 1934 ("Act"). Because registration of NASDAQ **as** an exchange will benefit the public and investors, **we are** compelled to correct the errors contained in the NYSE's letter,

The NYSE's position **is** that the only type of market that can be **an** "exchange" **is** a market that replicates its own auction market structure. This *is* incorrect **as** a matter of **law** and, if I may point out, self-serving. **In fact**, **examining** SEC-mandated order execution quality statistics demonstrates that **NASDAQ provides** the superior market structure by many important measures. Certainly, one need not resort to "back of the envelope" statistical arguments, **as** contained in the March 24 letter.

Simply put, the **NASDAQ** market structure is *the* superior market structure in the world **today**. If the NYSE structure were superior and if its point regarding price time priority were correct, then this would be revealed by superior **rates** for filling orders and narrower **spreads**. The contrary is true,

as the attached in-depth analysis by NASDAQ Economic Research shows,<sup>1</sup> **NASDAQ's** fill rates are **higher** and its **spreads** are narrower than the **NYSE's**. There **is** no contest in **speed**, as you would expect in comparing an all-electronic market with floor-based **specialists**.

We need not point out the numerous infirmities in the structure of the NYSE market to prove it would harm the public interest to require **NASDAQ** to be forced into the same structure. Why would the **SEC** want to allow **more** investors' orders to be 'pennied' as they are on the NYSE?<sup>2</sup> Why would the **SEC** want more companies to be **trapped** on the NYSE under the constraints of Rule 500, which makes it impossible for a company to choose freely **another** market? Why **would** the SEC want to lose the transparency of an all electronic, competing, market maker and ECN system for the **vagaries** of the floor-based, monopolistic, **specialist** system?

The **NYSE's** real goal is to force the **SEC** to "pick a winner" in the long-standing competition between the NYSE's specialist, market **model** and **NASDAQ's** all electronic, transparent and open model, which maximizes competition among **dealers** and ECNs.

Of course, Congressman, as you know, NASDAQ's exchange application **has** been pending for two years and further delay will inflict unnecessary harm on our market and deny the investing public the benefits of **NASDAQ's** exchange registration. These benefits include:

- Removing even the hint of a possible conflict of interest in the application of regulation by fully converting NASDAQ into an exchange with voluntary membership separate from the NASD and its compulsory membership requirements;
- Streamlining the governance of NASDAQ to eliminate the need to obtain the approval of two organizations and two **boards** for **decisions** that improve the market and **deal** with exigencies, such as **market** disruptions; **and**
- Enabling **NASDAQ** to compete fairly with **less** regulated for-profit Alternative Trading Systems ("ATs") in the U.S. and publicly traded **exchanges** around the world.

---

<sup>1</sup> Attachment A is Economic Research's analysis of economic issues, **like** fill rates and **spreads**, that are relevant to the time price debate. Attachment B is a general comparison of market quality between **NASDAQ** and the **NYSE** drawn from a statistical analysis produced by Market Systems Inc.

<sup>2</sup> "Pennying" or "stepping ahead" refers to the practice in which broker-dealers can trade **ahead** of customer orders after the orders have arrived on *the* floor **by** trading at a price that is one penny better than the **customer** order. See K. Kelly and S. Chang, *Big Board Is Probing Specialists for Possible 'Front-Running'*, The Wall St. Journal, April 17, 2003, §A, at 1

In the remainder of this letter, NASDAQ **responds** to the other errors in the NYSE's letter.

### **NASDAQ Is An Exchange in Everything But Name**

As a **threshold** matter, there is no doubt that **NASDAQ is**, for all practical purposes, an exchange **today**. Registration is simply legal recognition of current **reality**. The SEC has clearly stated that: "NASDAQ performs what **today** is generally understood to be the functions commonly **performed by a stock exchange**," and that "NASDAQ's use of established, non-discretionary methods bring it within the revised interpretation of 'exchange' in Rule 3b-16."<sup>3</sup>

In **revising** the definition of an "exchange" in Rule 3b-16 in **1998**, the SEC **engaged** in a detailed **analysis** of the types of entities that should be considered **exchanges** for purposes of the federal securities laws and **adopted** a more **expansive and** flexible interpretation. The Commission **stated that** this new interpretation complied with its "Congressional and judicial mandate to apply flexibly the definition of the term 'exchange' to the economic realm."<sup>4</sup> The **NYSE** chose to ignore this definition because it did not fit with its conclusion.<sup>5</sup>

The NYSE errs by **asserting** that exchanges do not report trades that occur off their facilities. In **fact**, when the SEC adopted its **revised** definition of the term "**exchange**" in 1998, it specifically permitted an exchange market structure in which members **use** the prices displayed on the exchange to execute **orders** not using the exchange's system.<sup>6</sup> Indeed, the NYSE regularly **reports** trades to the tape that do not interact with preexisting **trading** interest in their facilities.<sup>7</sup> NYSE members can submit "clean crosses"

---

<sup>3</sup> Securities Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844, 70852 (Dec. 12, 1998).

<sup>4</sup> *Id.* at 70899.

<sup>5</sup> In fact, Mr. Bernard of the NYSE (the author of the March 24 letter) stated on the record as part of last year's SEC market structure hearings, "[Y]ou're **probably** surprised that there is no **doubt** in my mind that **NASDAQ** meets the definition of exchange...." Transcript of Market Structure Roundtable, U.S. Securities and Exchange Commission, Washington, DC, October 29, 2002.

<sup>6</sup> In the release adopting the expanded definition of the term "**exchange**," the SEC included several **examples of** market structures that would meet the revised definition. These examples were **identified** as **Systems A through T**. **System G** describes **NASDAQ** as it operated prior to implementing its systems that provide automatic executions against quotes **displayed** in its market. Specifically, the SEC **stated** that "[s]ystem G permits competing market **makers** to post continuous **two-sided** quotes in certain securities. Quotes **are** consolidated and **disseminated** to subscribers electronically. **System G** maintains and **enforces** rules setting standards **for the** posting of quotes and executions. Trades are executed by subscribers **calling market makers** outside the **system** and **executing** trades based on quotes **displayed** in the **system**." **System G is included** under Rule 3b-16." *Supra* note 3 at 70855.

<sup>7</sup> The NYSE's rules (Rule 72) permit "clean crosses," which are agency cross transactions that **are** **executed** without interacting with preexisting trading interest on the specialist's limit order **book**. In approving these rules, the SEC noted how customer limit orders on the **book** could **be** ignored by the NYSE member wishing to execute the cross:

The Commission recognizes that approval of the clean cross proposal could disadvantage orders **on the book**, or **in the crowd**, at the price as the cross transaction. This is the only **aspect of** the proposal that really represents a departure from **existing** auction

that ignore **customer** limit orders on the NYSE's limit **order book**.<sup>8</sup> The only **nexus** between a clean cross and the NYSE is that it is NYSE member firm that reports the trade to the exchange. When **orders are crossed**, the **orders do not** interact with customer orders on the NYSE's book or other **trading interest** on the floor.<sup>9</sup> In addition, the Cincinnati Stock **Exchange**, an SEC-registered exchange, **allows** the Island ECN to match trades in its internal **systems and** report those trades to the public tape as Cincinnati's trades.

Regulators and **exchanges** in the United Kingdom, France and Germany permit trades executed **away** from the exchange to **be reported to that exchange as exchange** transactions. Unfortunately, the **NYSE** has chosen to ignore the SEC's statements and the trade reporting that occurs **every day** on the NYSE and other **exchanges around the world**,

### **NASDAQ's Market Structure Is Best For All Market Participants**

The **NYSE** is wrong when it states that **NASDAQ** market **makers are free** to buy or **sell** without yielding to public orders on **NASDAQ's** limit order book. **Today on NASDAQ**, public orders can, **and do**, meet without the intervention of a **dealer**, and **NASDAQ** does resolve conflicts in favor of customers.<sup>10</sup> In fact, **NASDAQ** market makers are prohibited from trading ahead of their customer limit orders, regardless of whether the limit order **is placed in NASDAQ's book** or routed to another market maker or electronic communications network.<sup>11</sup> This longstanding **NASDAQ** rule **is called** the

---

market principles. Thus, under the proposal, a **clean** cross could **be** executed while a public investor's limit order **on** the book remains unexecuted. For example, if a public customer left a limit order on the specialist's **book** at 10 a. **m.** bidding for 500 **shares of XYZ** at **40**, a so-called clean cross could **be executed** at 10:10 am at a price of **40** without satisfying the public customer order, Securities Exchange Act Release No. 31343 (Oct. 21, 1992).

<sup>8</sup> *Id.*

<sup>9</sup> **We do** recognize that in certain circumstances other **NYSE** members can "**break up**" the clean cross **by** offering to trade at a price that would improve the price at which the crossed orders were proposed **to be** executed.

<sup>10</sup> Certain **NASDAQ** rules prohibit **NASDAQ** market makers from trading **ahead** of their customer **orders**. See current **NASDAQ Rules** IM-2110-2 and 6440(f), which are replicated in **NASDAQ's** proposed exchange rules as **NASDAQ Rules** IM-2110-2 and 6440(f).

<sup>11</sup> The **NYSE's** letter also talks about the "negative" obligations **imposed** on exchange specialists **by** the Act that **prohibit** the specialist from trading unless it is necessary to meet their obligation to maintain a fair and orderly market. Unfortunately, the **NYSE** does not cite to any specific section of the Act supporting their statements. This **is because** a cite to Rule 11b-1 would reveal that the obligation is imposed **on** exchange **specialists**, not competing market makers. **NASDAQ does** not use specialists, but **instead** relies on **competing market makers** to guarantee that there will always be a buyer and seller for securities traded on its market.

The distinction between specialists and competing market **makers is** important and explains why Rule 11b-1 applies to specialists **and** not competing market makers. At the **NYSE**, a specialist is a broker-dealer that **has been granted** a monopoly in controlling the trading in its allotment of securities. Rule 11b-1 is designed **ameliorate** the advantages of this monopoly. In contrast, **NASDAQ** does not limit the number of broker-dealers that are permitted to display buying and selling interest **and** to compete for orders. In some stocks, more than 100 hundred market makers compete for orders. Thus, the **monopolistic** concerns inherent in the **NYSE's** **single** specialist model **do not** arise in a competing market maker structure that is the hallmark of **NASDAQ**.

Manning Rule, **and is** a customer protection requirement developed by **NASDAQ and the SEC to address** specifically a geographically **disparate** electronic **market**,

**Market makers** on **NASDAQ** are permitted, subject to **best** execution requirements, to trade with their customers without first executing other orders **displayed** on **NASDAQ's** SuperMontage. This concept, often referred to **as** internalization, **has** been permitted by the SEC since **NASDAQ's** inception in 1971 **and** provides incentives for market **makers** to **provide** automatic executions **for** their customers at **sizes** in **excess** of the displayed quotation **size**. This feature of our market structure adds liquidity for the **benefit** of the market **and** all market participants.

Internalization has **many** benefits for investors, especially small investors. These **benefits** include guaranteed executions **and fast** executions. With **respect** to market **makers**, stated another way, we permit market **makers** to guarantee that customer orders will be executed **at the best prices displayed**. To facilitate these guarantees, we **do** not force the market maker to **place** orders into a centralized trading system. Instead, we allow market makers to use the **prices displayed** in **NASDAQ as** a benchmark for executing **orders**. In many instances, this practice allows more orders to be **executed** at the **best** price than could ever be executed if all the orders were required to be submitted to a centralized trading system. With respect to ECNs, **we** permit them to match limit orders **as fast as** possible, which allows them to accommodate customers who value speed of execution more than obtaining an execution at the **best** price displayed. NASDAQ facilitates the ECN model by not requiring ECNs to submit their orders to a centralized trading system. These results are good for investors,

There are other critical **aspects** of *the* NYSE market structure that are ignored in the March 24 letter. For example, with the exception of small customer order executions, no one can **access a** NYSE quotation automatically without delay and no one can ever automatically access orders at multiple prices.

In 2001, the Investment Company Institute, which represents mutual **funds and** other large investors, complained to the SEC that the execution of large orders on the NYSE **was** being **hampered** by reduced **depth** of the NYSE's limit order book following the move to decimal pricing **and** because of market participants "**stepping ahead**" of those orders by increments **as little as one** penny.<sup>12</sup> Recent publicly reported developments only **serve** to validate these concerns.<sup>13</sup>

---

<sup>12</sup> Letter from Craig S. Tyle, General Counsel, ICI, to Richard A. Grasso, Chairman, NYSE, dated March 1, 2001. According to the **ICI**, "[d]ecimalization, **by** itself, is not the problem. Rather, it has simply **made** more apparent the difficulties that mutual funds **and** other institutions commonly face when trading **on** the exchange." In criticizing the NYSE's Institutional XPress system the ICI noted that **the system's** requirement that large **orders** in the system **be displayed for 30 seconds gives a** "free look" to market

**NASDAQ is a Public Company and Better Serves the Public Interest as a Public Company**

The London, Paris, Frankfurt, Tokyo and Hong Kong stock markets are all for-profit, public companies for a simple reason: **as public companies they are better able to serve the investing public, improve their markets and compete with other markets.** The **same** logic applies to **NASDAQ.** Of course, **NASDAQ's** ability to fund regulation and technology is enhanced **by its status as a public company.** With access to the capital **markets,** **NASDAQ** now has an additional source of funds to improve its **markets.**

**NASDAQ** has been a for-profit company paying **taxes** since 1979. **NASDAQ** completed **two private** placements to shareholders in 2000 and 2001, and currently **has** over 2000 shareholders. Its shares **are** publicly traded, **Exchange** registration will not change these facts. Exchange registration actually removes the potential for a conflict of interest between **NASDAQ** and **NASD,** **but** in **no** way diminishes the extensive SEC oversight **to** which it is subject.

Recent events have revealed how being a "cooperative," **as NYSE styles** itself, **allows** the NYSE to evade important investor protections like the Sarbanes-Oxley ("SOX") rules governing board composition **and** audit committee procedures. SOX and a wide range of **federal** securities **laws** that ensure appropriate disclosure for public companies are **far** preferable **to** govern **an** exchange than the secret operations of the NYSE "cooperative."

Further, what the NYSE fails to mention **is** that the "**cooperative**" generally **is composed** of the members that earn their income from **trading** on the **NYSE.** Does this type of structure guarantee that the public interest comes first? It **is** somewhat ironic that the NYSE is **questioning** NASDAQ's ability **to** enforce corporate governance standards at the time when the **NYSE** is being criticized for **its own** corporate governance shortcomings.

---

participants **who** want to **step ahead** of those orders. "As a result, institutional investors, knowing that large limit **orders on the book** are not **provided** protection and are likely to **be** 'penny jumped,' **have little,** if **any,** incentive to place **large limit** orders on the Exchange." See also Letter from Ari Burstein, Associate Counsel, **ICI,** to Jonathan **G. Katz,** **Secretary, SEC,** dated August 7, 2001, noting that the NYSE's decision to **lower** the **display** requirement from 30 seconds to 15 seconds **does** not "effectively address the most pressing concerns that our members have—inadequate protection of limit orders **placed** on the Exchange's limit order **book** and the inability of investors to effectively interact with those orders" **and** Letter from Junius **W. Peake,** Monfort Distinguished **Professor** of Finance, Kenneth **W. Monfort** College of Business, University of Northern Colorado, to Jonathan **G. Katz,** **Secretary, SEC** dated August 27, 2001, **noting** that the **ICI** did not go far enough in criticizing the **NYSE's** system, which "continues to favor **its** specialists **by** giving them time to react to **bids** and offers sen[t] to them before requiring execution." According to Professor **Peake,** "Many institutional investors are reluctant to expose their **orders** to the floor, since it provides a **golden** opportunity 'for those **with** advance[d] information to front run investors' orders, either for themselves or for **their** favored customers."

<sup>13</sup> See *also supra* note 2.



### **The Conflicts of Interest Inherent in Housing the Regulator and the Market in One Structure**

**NASDAQ has chosen** to become an exchange that is independent of the **NASD**, and to **use NASD as** its arms-length regulator. Simply put, the **NASD**, as the securities industry's primary self-regulator, believes **it should** avoid any appearance that its regulatory decisions are motivated by **NASDAQ's** commercial interest. This **is** a clear benefit and results in the most **unbiased** regulation **possible**. In contrast, the NYSE regulatory **and** commercial activities remain intertwined in the same entity and subject to the conflict between the **regulatory** and commercial interest, NASDAQ does not believe a **securities** regulator should have an economic stake in the **success** of a major financial institution.

### **One Last "Red Herring"**

Before **closing**, I want to put to rest one issue not mentioned by the NYSE but that some **have** raised in opposition to **NASDAQ's** registration: Concerns that approval of NASDAQ's exchange application would compel Commission **approval** of other **less** well supported exchange applications, or **proposals** by existing exchanges. Such concerns are misplaced. They are simply **part** of the "**scare** tactics" being used by our competitors.

The Commission's authority to condition or reject other **exchange** applications **premised** on much different factual **bases** cannot be seriously **doubted**. No applicant can reasonably expect approval of an application **seeking** similar treatment to NASDAQ unless the applicant has **very** similar **facts**. Here are just a few of the critical **facts** that support the NASDAQ application and distinguish it from other applications:

1. Over 25 **years** operating subject to Section 15A, which contains language virtually identical to the exchange standard in Section 6 ;
2. Self Regulatory Organization board structure in **place and** proven;
3. Proven regulatory services provider in the NASD;
4. Proven market structure;
5. Proven real time surveillance of market;
6. Proven and extensive market maker and ECN examination program; and
7. One of two well-established primary listing markets. ,

**Any** market seeking a rule structure **as** an exchange that replicates **NASDAQ's** rule structure should be required to demonstrate that **it possesses** the factual underpinning described above. In particular, to ensure the protection of investors, the Commission **could** require any such market to participate in, or **possess** a system similar to, the NASD's Order Audit Trail System ("OATS"), which can track an order from the time it is received **by** a

market **participant** up to and including the time the order is **executed**. To **test** the integrity and accuracy of the information submitted to **such a system**, the Commission also **could** require such a market to employ **staff** that **would** conduct on-site examinations of **market makers** and ECNs. Imposing these standards **is** consistent with the Commission's obligation to ensure that **a market is** organized in **a** manner that will **lead** to effective enforcement of **its rules** and the federal securities laws.

**Congressman Ose**, while Competition between exchanges is vigorous **today**, **NASDAQ must set** the record straight. We appreciate your interest in **these** issues of critical importance to American investors and the opportunity to **present** the **facts** accurately. Thank you for continuing to urge the **expeditious** resolution of our exchange application.

Sincerely,



Edward S. Knight

Attachments

# Market Quality Analysis using Data from Rule 11Ac1-5

Nasdaq Economic Research  
April 8, 2003

One of the few remaining policy issues concerning Nasdaq's exchange registration involves the concept of price-time priority. Presumably, the concern is based on the idea **that** price-time priority alone lowers transaction costs, particularly for retail investors. On **Nasdaq**, price-time priority is generally observed **on** individual **market** centers, but it is not observed between competing **market** centers. This note provides some **empirical** evidence addressing this issue. **Our analysis concludes there is no evidence that Nasdaq's market structure results in disadvantageous market quality for retail investors.**

The study approaches this issue from two angles: the first **compares** Nasdaq with the NYSE in terms of spreads and limit order fill rates; the second compares limit order fill rates across Nasdaq market makers.

The empirical **results** are drawn from data provided pursuant to Rule **11Ac1-5**, the SEC's standard for execution quality. Given the focus on **small** investors, all results presented herein **are** for orders from 100-499 shares. For the Nasdaq results, only orders **received** by market makers are considered. ECNs are typically not the destination of small retail orders. ECNs tend to cater to institutional, professional and semi-professional traders. Data from January 2003 are used. The data **are** provided to Nasdaq **by** an outside vendor, Market Systems, Inc. (MSI). **MSI** collects **11Ac1-5** data from all market centers **as** posted on public web sites, and stores it in an on-line database.

To summarize our findings, market makers in the Nasdaq Stock Market provide high quality executions. Nasdaq's trading environment offers low effective spreads for **market** orders, high fill rates for limit orders, **and** provides all investors tight quotes that accurately represent the market. The intense competition within Nasdaq's **market** structure produces significant benefits in cost, speed, and confidence for investors.

## NYSE vs. Nasdaq comparison

While **the** NYSE does not impose price/time priority in all circumstances, it can serve as a reasonable **execution** quality benchmark for **this** analysis.<sup>1</sup> In drawing comparisons, one must ensure that the stocks analyzed are similar. The **study** compares **execution quality** based on two groups of stocks: those in **S&P 500**, **and** those in the **S&P MidCap 400**. **Each** index contains both Nasdaq-listed and NYSE-listed **stocks**. **Because**

---

<sup>1</sup> See, for example, NYSE Rule 92 permitting clean cross trades. See also section 11B of the SEC's *Report on the Practice of Preferencing* (April 15, 1997), available at <http://www.sec.gov/news/studies/prefrep.htm>, which discusses deviations from price-time priority on registered securities exchanges.

of the selection criteria **used** by Standard and Poor's, the stocks in each group **should** be reasonably **similar**.<sup>2</sup> Nasdaq market **makers** receive orders for NYSE-listed **securities** as **well as** Nasdaq-listed securities. Nasdaq's trading of NYSE-listed stocks occurs on **Nasdaq's InterMarket**.

Empirical results, representing weighted averages, are presented in accompanying figures.<sup>3</sup> These results demonstrate that Nasdaq's execution quality often **is** superior to the NYSE, according to several of **the** SEC's own **quality** measures. What is attempted herein, however, **is** not so much a strict "horserace" between Nasdaq and NYSE to conclude which **market** is "**better**."<sup>4</sup> Rather, the results are meant to provide a general representation of the execution **quality** experienced by retail investors on **Nasdaq** and the NYSE, **Whatever concerns one may have with Nasdaq's market structure as it relates to price-time priority, the results do not indicate deficiencies in Nasdaq's structure, using the NYSE as a benchmark.**

### *Effective Spreads*

Figures 1 and 2 show average effective spreads for the S&P 500 and S&P MidCap 400 stocks. The figures show NYSE **spreads** for the NYSE-listed components, Nasdaq InterMarket **spreads** for the same stocks, and Nasdaq **market maker** effective spreads for the Nasdaq-listed components. **Nasdaq spreads are lower, especially for the S&P 500 stocks.**

### *Price Improvement/Disimprovement*

The effective spread represents the appropriate all-in measure that matters to small market-order investors. It impounds the impact of whatever price improvement or disimprovement has occurred. To some extent, given the effective spread, the incidence of price improvement is an irrelevant statistic. Nevertheless, price improvement/disimprovement results may be of interest as they relate to the relationship between the fill price of a market order and the quotes that prevailed when the order was **received**.

---

<sup>2</sup> Standard and Poor's describes the S&P 500 Index as: "**Widely regarded as the standard for** measuring large-cap U.S. stock market performance, this popular index includes a representative sample of leading **companies in leading industries**." There **are** 75 Nasdaq-listed stocks in the index. Standard and Poor's **MidCap 400 index** is described as: "Measuring the performance of **the mid-size company segment** of the U.S. market, this index is **used by** over 95% of U.S. managers and pension plan **sponsors**." There **are** 113 Nasdaq-listed **Stocks in this index**.

<sup>3</sup> All results shown in this study **are** share-weighted **averages**. For the **NYSE**, the **averages** are calculated over stocks. **The** weight for each stock is **the** number of **executed** shares, a data **element** provided in 11aC1-5 submissions. For **Nasdaq**, the **weighted averages** are calculated **over** stocks and market makers. Again, the weights are the number of executed shares for each stock/market maker combination. The calculation of the weighted averages is **done** by **MSI**.

<sup>4</sup> There **are many** complexities **inherent** in performing a comparative analysis of markets **that** are not addressed **in this** study. See, for example, the discussion of **this** topic in "Report on the Comparison of Order Executions **Across** Equity Market Structures", U.S. Securities and Exchange Commission, Washington, DC, **January 8, 2001**.

Price improvement is clearly beneficial for the market order **investor**, **though** the benefit may come at the expense of whatever order or quote **was** prepared to **take** the other side of the trade. Price improvement may lower the fill rates of limit orders. Further, **price** improvement by a specialist or dealer—stepping ahead **of** previously **placed orders** for what is arguably an economically insignificant amount of money—effectively thwarts the **use** of time **as** a secondary **priority**.<sup>5</sup> Anyone advocating strict price-time **priority** cannot look too favorably on selective price improvement by **a** dealer possessing the time/place advantage of an exchange **specialist**.

Price disimprovement obviously works against the interests of the market order investor, though it may benefit a limit order investor. In **any** case, **it** undermines the value of real time quotes. If quotes are meaningful to anyone, they should **be** meaningful for **small** market-order investors, who should **expect** to get their entire order filled at no worse **than** the quoted price.

Figures 3 and 4 examine the incidence with which small market orders are filled inside, at, and outside the quotes at the time of order receipt. While the NYSE tends to provide more **price** improvement than Nasdaq market makers (trading Nasdaq stocks), **they have** much more price disimprovement. Nasdaq InterMarket **market** makers provide more price improvement than the NYSE, with less price disimprovement. **In sum, the inside quotes are more meaningful for trading done on Nasdaq—a small market order on Nasdaq is highly likely to obtain an execution at, or better than, the prevailing best quote.**

There may be several factors that might explain the different results for **small** maker orders executed on each market. NYSE specialists, perhaps **due to the** more manual way trades are **executed**, seem to have a harder time matching **a fill price to the** quotes at order receipt time (as **opposed to** execution time). Nasdaq market makers' greater precision **may be** due at least partially to the fact that small **market** orders are filled more quickly, usually using automated systems. In many circumstances, the quicker automated executions are the result of Nasdaq market makers internalizing these orders.

#### *Limit Order Fill Rates*

Perhaps the main issue tied to price-time priority concerns the fill rate of limit orders. **Suppose**, goes the **argument**, an aggressive, spread-narrowing limit order arrives at **some** market center. Later, a market order going the other **way is** submitted, but to **a** different **market** center. The **latter** has **the** option of filling the market order **at** the best inside **price**. If it does, the market order investor benefits from the limit order's aggressive **price**, yet the limit order does not get a fill. Conceivably, if it became **clear** to investors that placing aggressive limit orders yielded no benefit, such activity would **stop**, along with it the potential for narrowing the spread. Such a scenario, termed "limit order isolation," could **be** remedied if time priority were observed **across** market centers.

---

<sup>5</sup> Far S&P 500 stocks, the average amount of price improvement on the NYSE, **when it occurs, is** 2.4 cents. The same **figure** of S&P MidCap 500 stocks **is** 2.6 cents.

An indirect symptom of limit order isolation would therefore be wide spreads. As shown above, though, there is no evidence of wider spreads on Nasdaq. A second way of looking for evidence of limit order isolation is to analyze limit order fill rates directly, as provided in the 11Ac1-5 data. Figures 5 and 6 provide, for the S&P 500 and MidCap 400 stocks, cumulative fill rates for the three groups of market centers under analysis. Fill rates for investor limit orders that are priced inside the quotes are shown. Each figure provides the fraction of shares executed during the time frame indicated. In both cases, the rates provided by Nasdaq market makers are higher, whether in the InterMarket, or for Nasdaq-listed stocks. The InterMarket results are particularly noteworthy since they apply to the same set of stocks as the NYSE results.

The figures also indicate the fraction of shares that are cancelled. Clearly, there is a much higher fraction of shares cancelled on the NYSE. The existence of cancellation makes it impossible to determine, definitively, which market delivers the highest fill opportunities. The reason is that we do not know why the orders were cancelled. Suppose an order submitted by a patient investor is cancelled due to the investor becoming discouraged that the order will never fill, even though he sees trading at his price. The market may be "at fault" to some extent in this case. On the other hand, if the cancellation stems from some type of investor strategy in which an order's price must be continually updated to reflect changing conditions (leading to frequent cancellations), then the submitter, not the market, bears primary responsibility for a low observed fill rate. This type of strategy appears to be dominant among the users of ECNs. Since data from Rule 11Ac1-5 do not indicate the timing of the cancellation, it is impossible to determine the extent to which low fill rates on the NYSE are due to market structure inadequacies or submitter strategy.

There are two other classes of limit orders covered by Rule 11Ac 1-5. These are At-the-Quote and Near-the-Quote orders. Analysis of these order types yields results (not shown) that are qualitatively identical to those shown in Figures 5 and 6: fill rates are higher at Nasdaq market makers.

In sum, then, while observed limit order fill rates as provided by Rule 11Ac 1-5 data cannot be taken as conclusive as to which market provides the highest opportunity for a fill for a given order, evidence presented in Figures 5 and 6 clearly provide no evidence of a fill rate deficiency on Nasdaq. Accordingly, there is no support for the proposition that lack of universal time priority among Nasdaq market makers creates some sort of limit order isolation.

### Limit Order Fill Rates Across Nasdaq Market Makers

There is another way to look for evidence of limit order isolation, which is addressed in this section. If isolation were a problem, one might expect to see some Nasdaq market makers with high limit order fill rates, others with low fill rates. In particular, one might expect that limit orders placed at large market centers, centers with abundant market order flow going in both directions, would have higher fill rates compared to smaller market centers, where limit orders are more likely to be isolated.

Rule 11Ac1-5 data can be used to compare fill rates across Nasdaq market centers trading Nasdaq-listed stocks. To control for stock composition, we again use S&P index

membership to create groups of similar stocks. **Again, we cannot** control for differing **investor** strategies with respect to cancellation. Some market centers may **receive** orders from investor clienteles that **have** systematically higher cancellation tendencies that would tend to **lower** their observed fill rates.

Figure 7 provides the overall fill rate for *each* reporting **market** maker for Inside-the-Quote limit orders. In the graph, the market centers **are** arranged in terms of **the** number of covered orders received, from lowest to highest. In the case of a tie, the **market makers** are arranged in alphabetical order. (For reference, the overall NYSE limit order fill rate for NYSE-listed S&P 500 components **is** also shown.) **As** indicated, there is tremendous variation in the number of orders received. Seven market makers received only one order during the month. At the other extreme, the top recipient (Knight Securities) received more than 5,000 orders. The figure shows some variation in fill **rates** at the **low** end. Recognize, though, that the **market makers** represented at that end received only a handful of orders. Once the number of orders received exceeds about 10, the fill **rates** exhibit greater uniformity, tending to exceed 80%. **Above** 50 orders received, only two market centers stand out with fill rates less than 50%: State Street (**30%**) and Jefferies (45%). Interestingly, State Street is not a registered market **maker**, and it routes 100% of its orders to other market centers, Jefferies is a well-known agency brokerage, which caters primarily to institutional investors. Eliminating these **two** firms from consideration substantially increases the level of uniformity of fill rates.

The relationship between the size of the market maker and its fill rate **is** better illustrated in Figure 8. This figure shows the average fill rate for **various** size categories of market **makers**, **as** labeled. The number of market makers in each category is also indicated. Averaging fill rates within size categories reduces some of the **variation** seen in Figure 7, providing a better view of the size/fill rate relationship. The figure indicates, if anything, an inverse relationship between the number of orders received and the fill **rate**: larger market makers **have** slightly lower fill rates.<sup>6</sup>

Figure 9 shows fill rates for Inside-the-Quote limit orders received **for** Nasdaq-listed stocks in the S&P MidCap 400 (the NYSE fill rate again shown for reference). For these stocks, there is somewhat greater variation in the fill rates than was seen for the S&P 500 stocks, likely due to the less-active nature of the stocks. **One market center**, VFinance Investments, received **9** orders, and none were filled. These 9 orders amounted to only 1,900 shares however. Figure 10 shows average fill rates for **size** categories of market **makers**. **Like** Figure 8, if anything there is an inverse relationship between the number of orders received and the fill rate. There is no evidence that limit orders sent to

---

<sup>6</sup> This result may be due to the composition of stocks traded. The largest market makers are Knight **and** Schwab, both firms that specialize in **making markets for** a wide cross-section of **stocks**. It is likely that both **of these firms trade** a disproportionately large fraction of the less-active **stocks** in the group. These **less-active stocks**, for natural reasons, would likely have lower limit order **fill rates**, **pulling down** the overall firm **average** fill rate. A second reason may stem from the client **base** of these firms. The larger market makers tend to **draw** much of their **business** from on-line discount **brokerages**. These brokerages **cater primarily** to self-directed investors, who **are** likely to control their **trading** strategies to a greater **extent** than do the customers of full-service firms. This higher **degree** of control could account for the **observed** higher rates of cancellation.

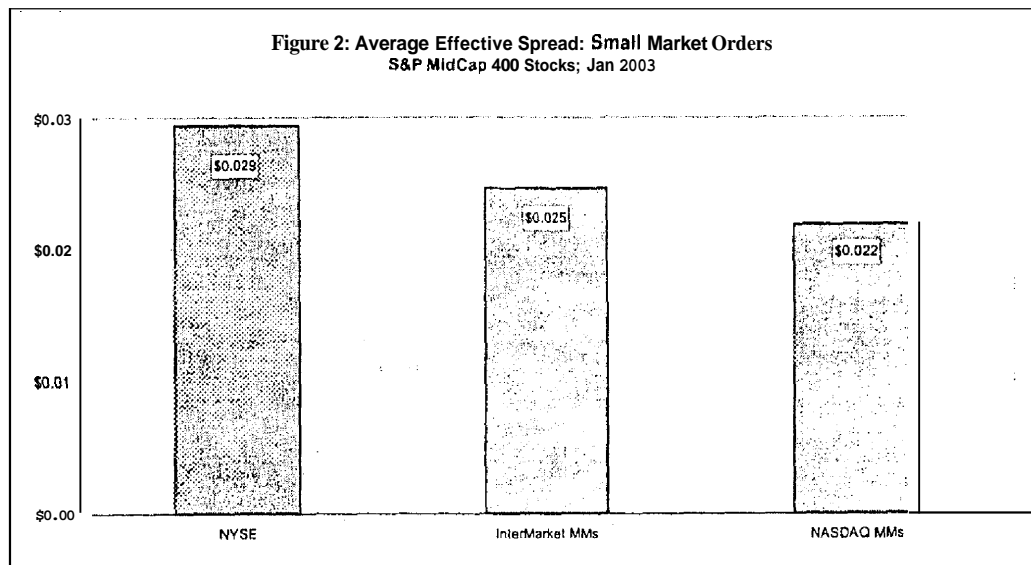
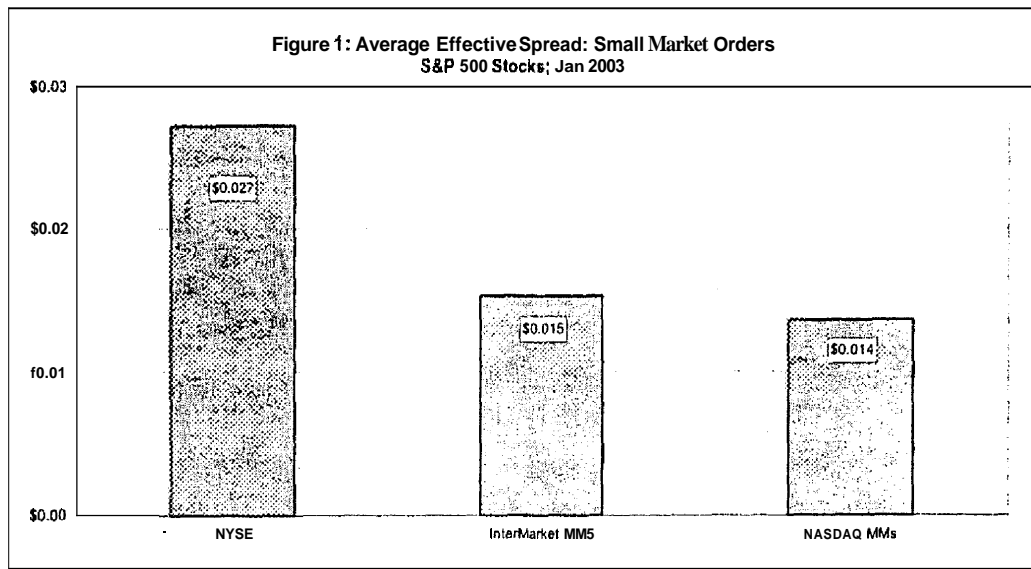
smaller **market** makers systematically suffer from lower fill rates as **compared** with orders sent to **larger** market **makers**.

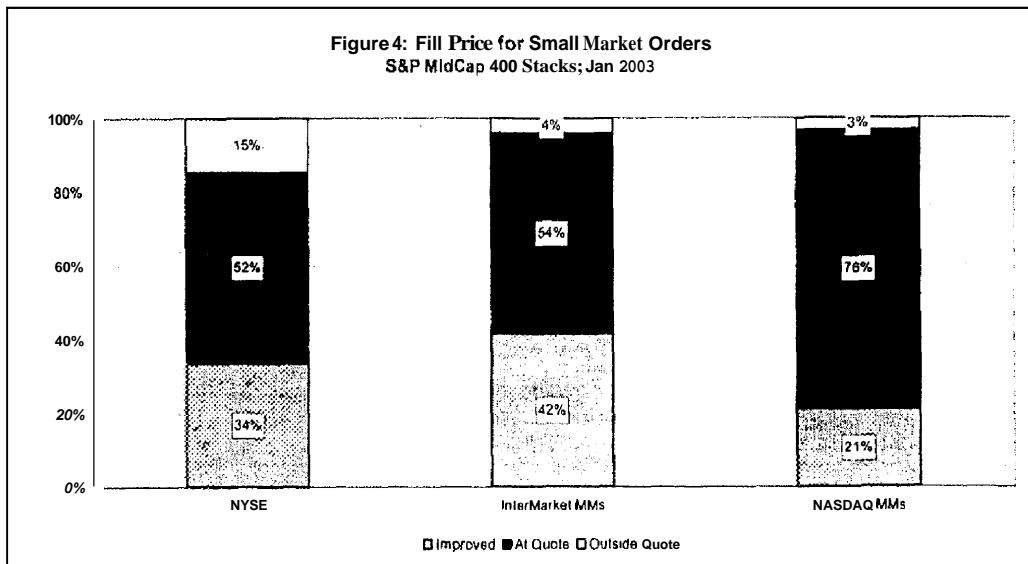
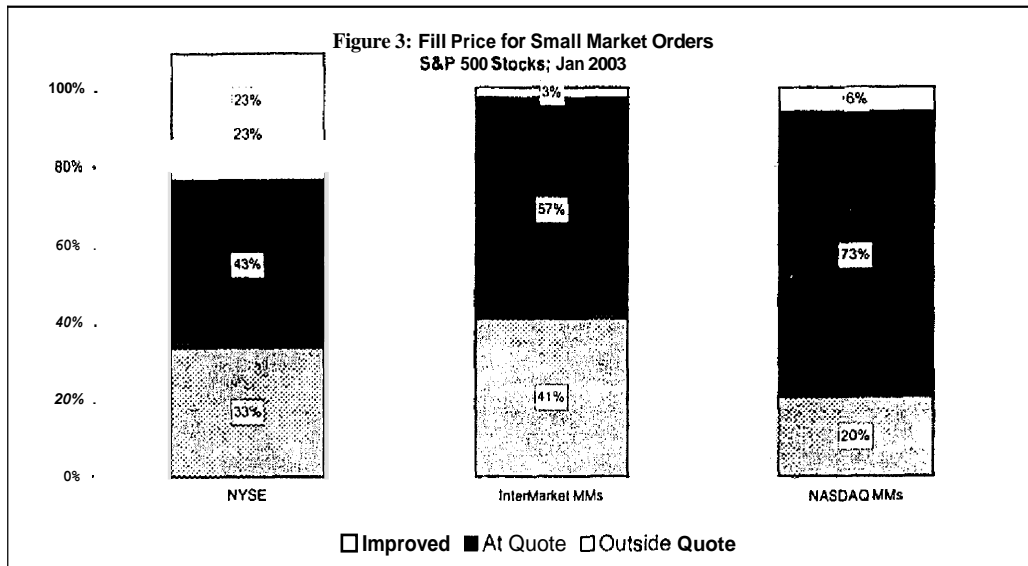
## **Conclusion**

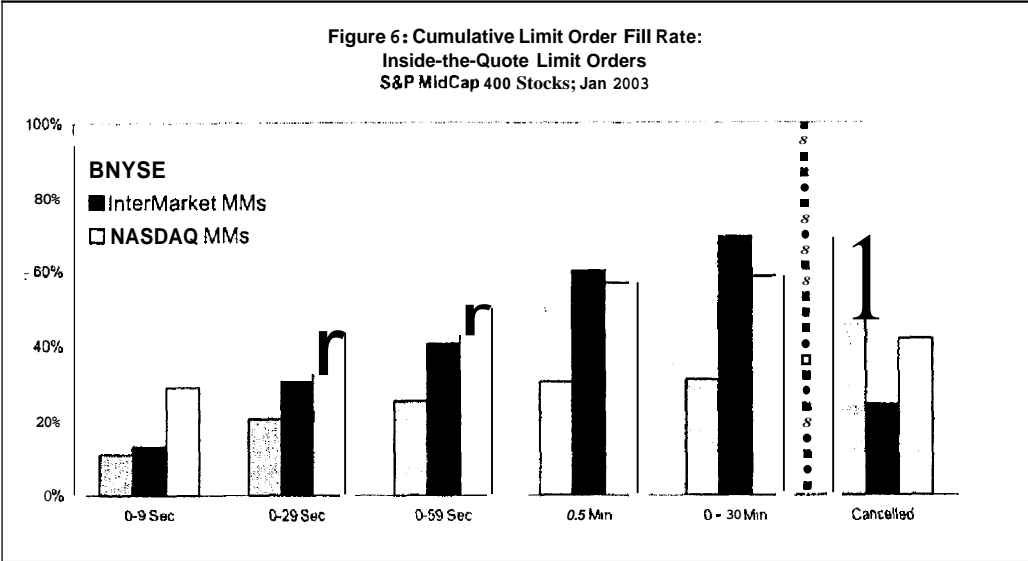
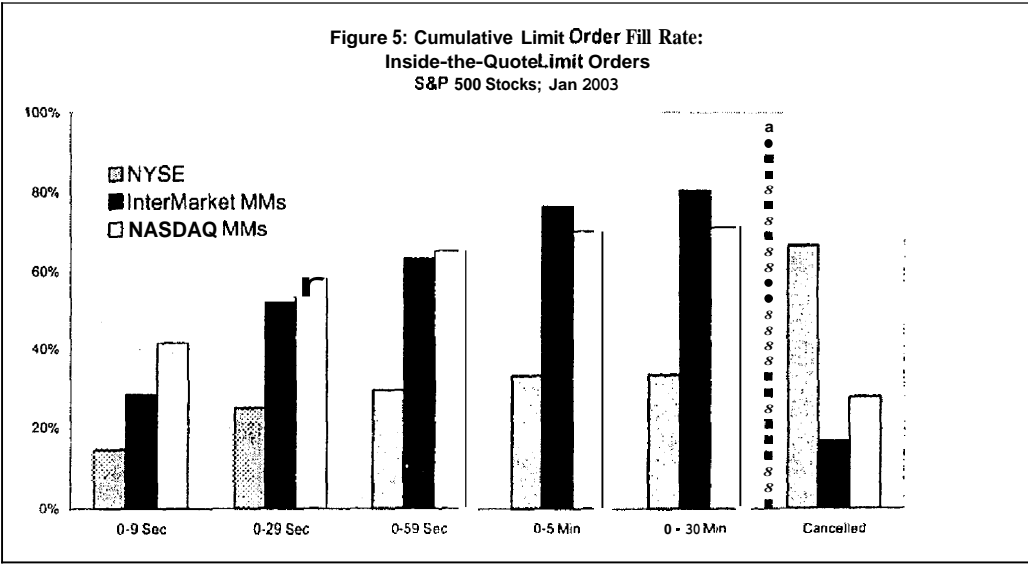
This note reports on analysis conducted using data from Rule 11Ac1-5 **submissions**. **At** issue is the question of whether **small**, retail limit orders are disadvantaged on Nasdaq, due to the lack of time **priority** across **market** centers. The evidence suggests not.

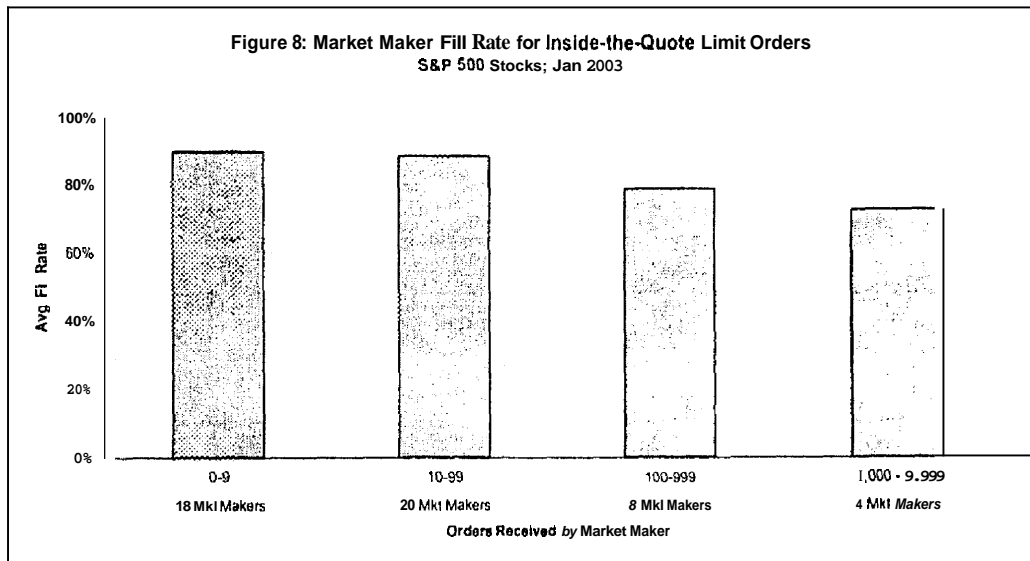
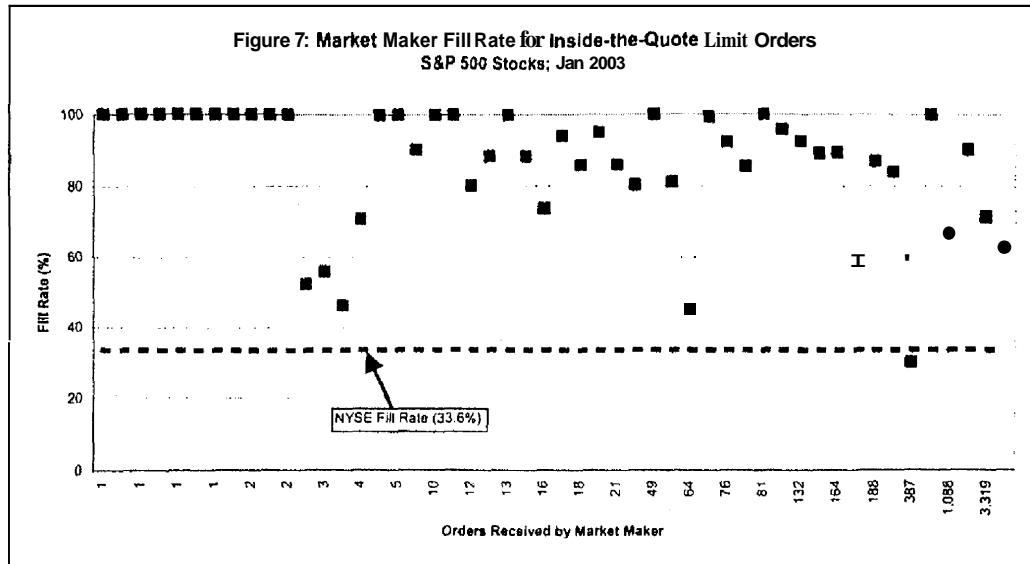
When compared with the NYSE, Nasdaq market **makers provide** tighter **effective** spreads, fills closer to the quotes, and higher limit order fill rates. This result **holds** for orders **submitted** for both NYSE-listed and Nasdaq-listed stocks. Looking across **Nasdaq market makers**, there is no evidence that limit orders are systematically isolated **when** submitted *to* certain market makers. Fill rates are high, even for orders sent **to** very **small** market makers. **Those who would argue that Nasdaq's market structure would be enhanced by imposing a global price/time priority rule will not find evidence of market quality deficiencies from the results shown by SEC-mandated execution quality statistics.**

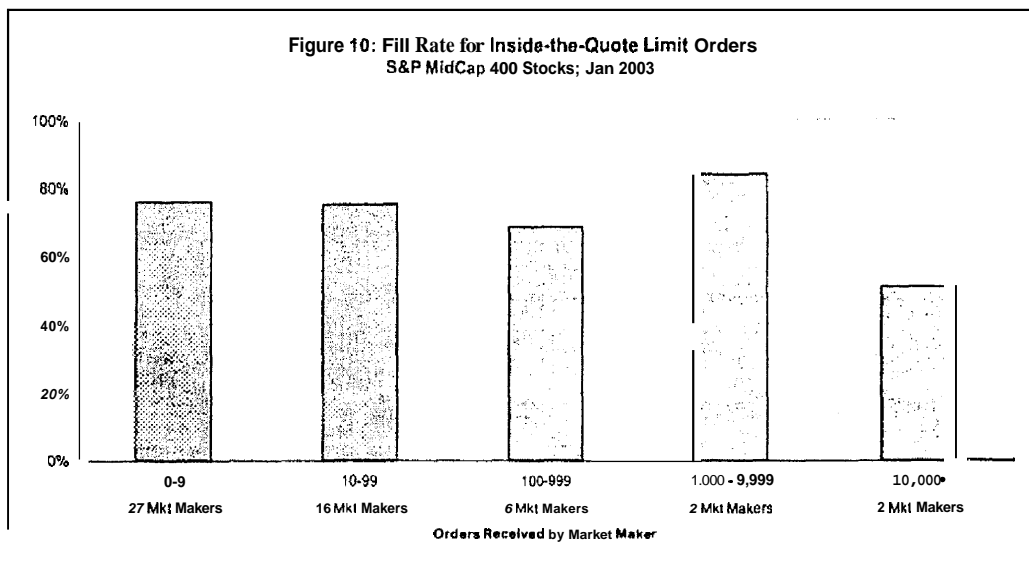
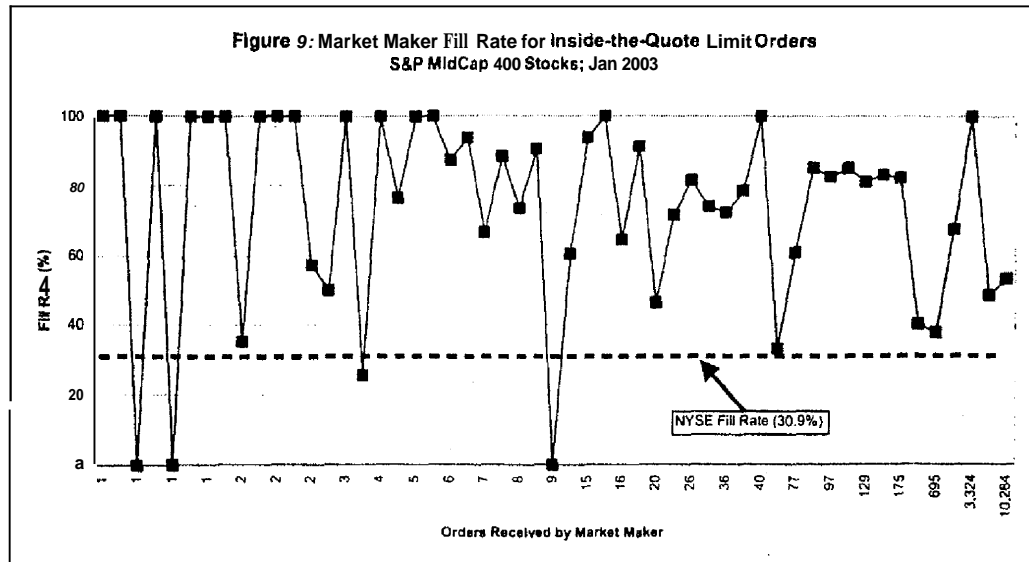












NASDAQ" is the world's largest electronic stock market. With approximately 3,600 companies, NASDAQ is home to category-defining companies that are leaders across all areas of business including technology, retail, communications, financial services, media and biotechnology industries.

- NASDAQ is an electronic stock market, an open and decentralized trading venue for millions of investors worldwide, and a source of capital and center of liquidity for thousands of diverse companies.
- NASDAQ is a provider of financial services, a developer of sophisticated and innovative investor tools, financial products and instruments used and traded on NASDAQ and other markets.
- NASDAQ is a technology services company, a provider of advanced trading systems, data products and tools that deliver more efficient solutions and essential market information to the investment community.
- NASDAQ is a global brand, a forward-looking brand that represents an enterprising American ideal admired and desired worldwide: the promise of unbounded opportunity, the power to change what's possible and the potential to succeed.
- NASDAQ is a market of integrity, a fair, level and well-regulated playing field for all the parties that make up the core of today's investment community: institutional and individual investors and traders, market participants, broker-dealers and listed companies.

Starting in 2001, the Securities and Exchange Commission (SEC) mandated that uniform trade statistics be reported by all market centers. The latest numbers are in, and analysis of the data obtained from third-party data provider, Market Systems Inc., clearly demonstrates that NASDAQ delivers superior execution quality compared to our primary market competitor. How is this a win for investors?

*The information in this document*

*is based on January 2003 SEC Rule 11Ac1-5 statistics for comparable NASDAQ- and NYSE-listed securities in the S&P 500 Index, companies 101-500 in the S&P 500 Index, and the S&P 400 MidCap Index.*

*The statistical analysis was produced by the Market Systems Inc. (MSI) Web site. MSI is a third-party vendor that compiles 11Ac 1-5 execution quality statistics; NASDAQ subscribes to their service.*

## **Faster Execution Speed**

- NASDAQ's speed means there is less trading uncertainty — less likelihood of the market moving away from an investor's price.

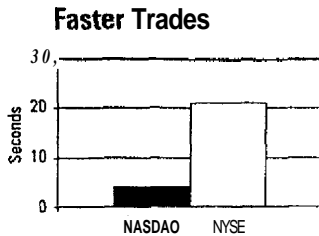
## **Superior Quoted Spreads**

- Tighter spreads between bid and ask prices on NASDAQ mean better prices, benefiting investors and traders alike who are accessing liquidity.

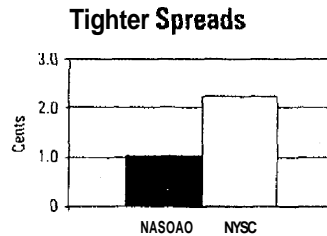
## **Lower Transaction Costs**

- Investors enjoy lower effective spreads on NASDAQ. Lower effective spreads lead to lower trading costs, which means investors can put more toward their investments rather than covering a wide spread.

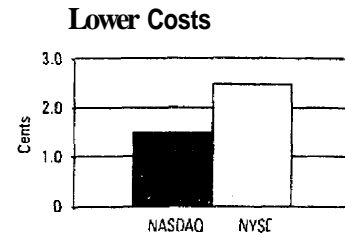
## S&P 500 Stocks Trade Better on NASDAQ™



- NASDAQ executes in an average of 4.0 seconds
- NASDAQ is 5.3 times faster than the NYSE

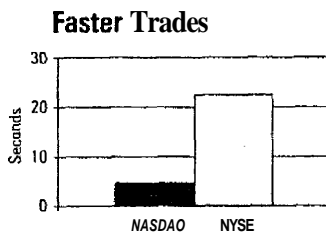


- NASDAQ is 53% better than the NYSE

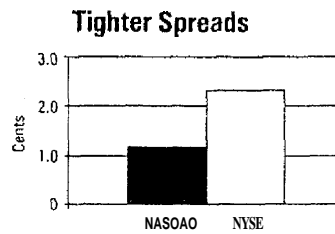


- NASDAQ is 40% better than the NYSE

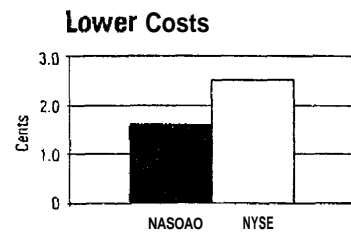
## Companies 101-500 of the S&P 500 Trade Better on NASDAQ™



- NASDAQ executes in an average of 4.7 seconds
- NASDAQ is 4.8 times faster than the NYSE



- NASDAQ is 50% better than the NYSE



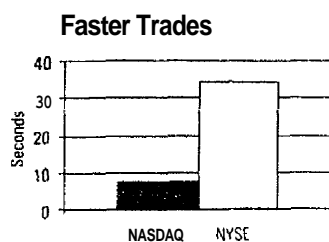
- NASDAQ is 36% better than the NYSE

\* Average Quoted Spread for S&P 500 Companies  
All Marketable Orders, All Order Sizes

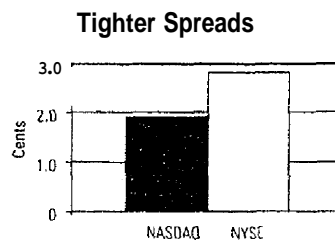
\*\* NASDAQ and NYSE Average Quoted Spread for S&P 101-500 Companies  
All Marketable Orders, All Order Sizes

## S&P 400 MidCap Stocks Trade Better on NASDAQ\*\*\*

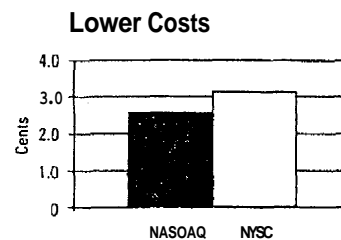
NASDAQ's superior execution quality extends to smaller companies as well.



- NASDAQ executes in an average of 7.5 seconds
- NASDAQ is 4.6 times faster than the NYSE



- NASDAQ is 31% better than the NYSE



- NASDAQ is 20% better than the NYSE

It's no surprise, With continuously improving technology and a competitive and open model, NASDAQ beats its primary market competitor in delivery of fast, reliable trading to investors and is setting new standards for market quality.

\*\*\* NASDAQ and NYSE Average Quoted Spread for S&P 400 Companies  
All Marketable Orders. All Order Sizes